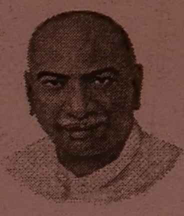
MADURAI KAMARAJ UNIVERSITY



(University with Potential for Excellence)

DIRECTORATE OF DISTANCE EDUCATION

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M.Com.
Second Year

ADVANCED ACCOUNTING

Volume - 2 & 3
Lessons : 6 - 21

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Dear Student

It gives us immense pleasure in welcoming you to the first year M.Com, Degree course through correspondence. While extending our warm welcome we also take this opportunity to wish you a bright academic year. You are expected to take the University examination in all the four papers.

1. Advanced Accounting
2. Financial Management
3. Advanced cost Accounting
4. Investment Management

Each paper carries 100 marks with 3 hour duration for each examination.

Teaching Accountancy through correspondence is not so easy particularly at post graduate level. Though we try to elucidate the principles involved in different chapters with carefully selected illustrations, mere reading of these problems alone will not help you. Accountancy is a subject which requires constant practice. Moreover, as you are going to face the post graduate examination a sound and deep knowledge of the subject matter is normally expected. As such you are directed to work out as many advanced problems as possible on each and every chapter falling under the syllabus. Constant exercise alone will give you courage and confidence to face the University examination. We agree that the time at your disposal is very short. But it is up to you to provide it substantial part of the day towards your study to have a regular systematic preparation. Only sheer hard working during this academic year is going to fetch you a bright and prosperous future, the fruits of which you are going to enjoy throughout your life.

In this lesson we have provided you with the syllabus, list of reference books, list of lessons that you will get in accountancy.

Yours Sincerely,

Staff

LESSON -6

COMPANY ACCOUNTS

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6.1. INTRODUCTION

There are businesses which require lakhs and sometimes even crores of rupees as capital which a single individual or few persons find it difficult to invest. Besides, in a sole proprietorship, the liability of the proprietor is unlimited. So it is also in a partnership. Thus the risk is sometimes too great for a few men to bear. With a view to remove the difficulties, the law has provided another form of business organization called the joint Stock Company in which number of members can exceed the limited prescribed for partnership and in which, at the same time, their liability is Limited.

In our country, Joint Stock Companies can be formed either by Special Act of parliament or a state Legislature or by incorporation under the Indian companies Act 1956. Most of the Companies are formed under the second method. Persons who which to form a company must prepare and sign a document, called the Memorandum of Association, which, when registered with the Registrar or Joint Stock Companies, give the company its existence and regulates its being. A further document called Articles of Association signed by the same person's is also registered. In order to place on record the rules of by-laws regulating the conduct and management of the company. Its existence is evidenced by a certificate of incorporation which is issued by the Registrar of Joint Stock Companies. The word Limited must be added to its name, if the liability of members is limited. Where a

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company is formed for promoting a arts, science, religion etc, then it may be registered without the addition of the word 'Limited' to its name. If it is a private company, it will add the words 'Private Limited' after its name. A company may be formed on the basis of unlimited liability.

A Public Company is not subject to these conditions.

6.2 BOOKS OF ACCOUNTS

Section 209 of the Indian Companies Act requires a company to maintain such books as will give a true and fair view in respect of :-

(a) All sum of money received and expended by the company and the matters in respect of which the receipt and expenditure take place.

(b) All sales and purchases of goods by the company and

(c) All assets and liabilities of the company.

Books of Accounts must be presented for a minimum period of 8 years.

These books are open to inspection of Directors, the Registrar and offices authorized by the Central Government. We have already given the accounting problems relating to Sole Proprietorship and partnership Lesson 9 to 14 will discuss the accounting problems relating to companies.

6.3 SHARE CAPITAL

Before starting an organization, the promoters have to think about the problem of finance. It is the duty of the promoters to decide upon the amount of capital which the company would require for its business during its existence. A large amount may be required for making investigations. This amount is supplied by promoters prior to incorporation. They must take into account the amount required for the Block Capital (i.e. for the purchase of fixed assets like Machinery, land and Buildings and the payment of formation expenses) as well as the amount needed for Working Capital (i.e. for the purchases of raw-materials and the payment of recurring expenses). The amount thus, estimated is laid down in the capital clause of the, memorandum of Association of the registered and which it is authorized of raised from the public by the issue of shares. This amount is, therefore, called the Registered of Authorized or Nominal Capital of the company.

Example 1

A company is registered with a capital of Rs.50,00,000 dividend into 50,000 shares of Rs.100 each. The authorized capital of company would be Rs.50,00,000.

It is not necessary that shares should be issued to the full amount of the authorized capital. Very often only a small proportion of the authorized capitals is, in fact, issued. The portion of the authorized capital which is offered to the public subscription is known as the issued Capital, the portion not yet allotted is called the Unissued Capital.

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Classification of shares:

1. Equity shares
2. Preference shares

What are preference shares?

Stock whose holders are guaranteed priority in the payment of dividends but whose holders have no voting rights

Example 2

Suppose, the company offers to the public only 40,000 shares of Rs.100 each out of an authorized capital of Rs.50, 00,000. Its issued capital would be Rs.40, 00,000 and unissued capital Rs.10, 00,000.

6.3.1 PREFERENCE SHARES & 6.3.2 EQUITY SHARES

The Capital of a company is divided into a number of equal parts. Each such is known as share. Now two classes of shares only are permitted.

(A) Preference Shares (B) Equity Shares

Preference share carriers a preferential right in respect of dividends at a fixed rate and in regard to repayment of capital. (If a Preference Share does not carry the above two rights it will be deemed to be an Equity share). Equity share are those shares which rank for divided and repayment of capital after the claims of Preference shareholder are satisfied.

6.4 ISSUE OF SHARES

When a public Company has been registered, its directors issue an invitation or public appeal to purchase its share and debentures. This invitation is called prospectus. A Private Company cannot issue such a prospectus and can raise its capital by making private arrangements. If a public company is able to make arrangements for sale of shares and debentures, it has to prepare a statement giving all the information which is required to be given in the prospectus. Such a statement is

known as Statement in lieu of prospectus. Prospectus or statement in lieu of it has to be filed with the Registrar or Joint Stock Companies.

A prospectus always mentions the number of shares issued or number of share offered to the public, minimum subscription application money etc. After the issue of prospectus, the company will have to wait for a few days before it can know the number of share to be allotted. The applications and application money are continuously received and deposited in bank for a number of days. If the public has applied for shares equal to minimum subscription the directors will consider the applications.

Journal Entries:

I. On receipt of application money, the following entry is passed

With the actual amount Received	Bank A/c Dr To Share Applications A/c (Being the application money on Share at Rs. per share received)

The next step is all the applications received from the public will be placed before the Board of Directors who will then scrutinize them and will decide which applications are to be accepted fully which applications are to be accepted partially and which applications are to be rejected in total. All applicants are informed accordingly letter of Allotment are sent to those who have been allotted shares and Letter of Regret are sent of those whose applications have been rejected. Letters of Regret are must be accompanied with the refund of the share application money. On partially accepted application, the surplus application money will not be refunded but

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will adjust against allotment money due and calls if any due. Shareholders are debtors to the company for money due from them on allotment.

II. **On allotment of shares the following entries are passes**

Application money (on the number of shares allotted which was formerly a deposit with the company becomes part of its share capital	2. Share Application A/c Dr To * Share Applications A/c (being the application money on Shares at Rs .... per share as per Board's Resolution dated ....)
Allotment money due from the persons to whom share have been allotted	3. Share Allotment A/c Dr To * Share Capital A/c (being the application money due on Shares of Rs .... per share as per Board's Resolution dated ....)
Actual allotment money received from the share holders	4. Bank A/c Dr To Share Allotment A/c (being the allotment money on shares of Rs .... per share received)
Refund of Application money on rejected Applications	5. Share Application A/c Dr To Bank A/c (being the refund of application money on rejected application as per Board's Resolution dated ....)
Transfer of surplus Application to Allotment Account on partially accepted Applications	6. Share Application A/c Dr To Share Allotment A/c (being the surplus applications now adjusted against allotment money due from them as per Board's Resolution dated ....)

(N.B: If a person fails to pay allotment money, he fails to become a shareholder of the company and his name will not be entered in the Register of Members. Only those persons who pay the allotment money are entitled to be called shareholders and only their names will be entered in the above Register) The balance due on shares may be called by directors in installments as laid down in the prospectus. Letters making the call are sent to the shareholders when a call is made as

soon as the demand is made, shareholders become the debts of the company in respect of such calls.

* Here, we have to write either 'Equity' or 'Preference' according to the class of shares given in the problem.

iii) **On making calls the following entries are passed:**

Call money due from the shareholders in respect of the call	7. Share I Call A/c Dr To Share Capital A/c (being the I call money due on share of Rs. per share as per Board's Resolution dated ....)
Call money when actual received	8. Bank A/c Dr To Share I Call A/c (being the call money received on shares of Rs per share)

(N.B: If a shareholder commits a default in the payment of the call money due from him the amount received fails short of the account called up and the call A/c will show a debit balance. This is known as Calls - in arrear).

While preparing the balance sheet of the company such calls in arrears are deduced from the called-up Capital in order arrived at the paid-up Capital, Obviously, shareholders have to pay interest on such unpaid calls. Being an item of again, this interest will be transferred to the profit Loss Account. It is now-a-day, a popular practice to have only one account named Shared Application & Allotment A/c in place of two separate accounts named Share Application A/c and Share Allotment A/c. If such a joint account is opened. A few entries are saved.

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Illustration: 1

The Lakshmi sugar Works Ltd has a preference share capital Rs.10,00,000 divided into 20,000 shares of Rs.50 each payable Rs.10/- per share on application Rs.15/- per share on allotment and the balance on the first call and final call equally. The entire share are taken up and fully paid for by public. Pass the necessary journal entries to record the issue of share.

Working note:		Amount Due & Received
Preference shares on Application Rs.10	=	2, 00,000
On Allotment Rs. 15	=	3, 00,000
On I Call Rs. 12.50	=	2, 50,000
On Final Call Rs. 12.50	=	2, 50,000

Solution: Journal Entries in the books of Lakshmi sugar Works Limited

Date	Particulars	L.F	Dr.	Cr
	Bank A/c Dr To Pref. Share Application a/c (Being the application money on 20,000 shares at Rs.10 per share received		2,00,000	2,00,000
	Pref. Share Application A/c Dr To Pref. Share Capital a/c (Being the transfer of application money to share capital a/c)		2,00,000	2,00,000
	Prefer Share Allotment A/c Dr To Pref. Share Capital a/c (Being the allotment money due on 20,000 share at Rs.15 per share as per board's resolution dated)		3,00,000	3,00,000
	Pref. Share I Call A/c Dr To Pref. Share Capital a/c (being the first call money due on 20,000 shares at Rs.12.50 share as per Boards Resolution dated)		2,50,000	2,50,000
	Bank A/c Dr To Pref. Share First Call a/c (being the first call money received)		2,50,000	2,50,000
	Pref. Share Final Call A/c Dr To Pref. Share Capital a/c (being the final call money due on 20,000 shares at Rs.12.50 per share as per board's Resolution dated)		2,50,000	2,50,000
	Bank A/c Dr To Pref. Share Final Call a/c (being the final call money received)		2,50,000	2,50,000

Form of a Balance Sheet of a Company

The Company law governing the preparation of Final Accounts of a Company will be discussed in a subsequent lesson. At this stage, the assets and liabilities of a Company are to be shown in the balance Sheet in the order stated

.... Co Ltd Balance Sheet as at

Liabilities	Assets
1. Share capital Authorized, Issued, Subscribed etc	1. Fixed Assets
2. Reserve & Surplus	2. Investments
3. Secured Loans	3. Current Assets, Loans & Advances
4. Unsecured Loans	4. Miscellaneous expenditure
5. Current Liabilities and Provisions	5. Profit & Loss Account

Contingent Liabilities: As foot note

The term 'surplus' means credit balance of the profit and Loss A/c.

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What is balance sheet?

A record of the financial situation of an institution on a particular date by listing its assets and the claims against those assets

What is surplus?

A quantity much larger than is needed

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Illustration: 2

Trichy National Cotton Mills Ltd was registered with an Authorized capital of 20,000 Equity Share of Rs.10/- each. The company offered to the public for subscription 10,000 shares which are payable as under.

Rs. 2 on application	Rs. 3 on allotment
Rs. 3 on first call	Rs. 2 on final call

The public applies for 15,000 shares. The directors make the allotment as under:

(a) To applicant of 7,000 shares	Full
(b) To application of 5,000 shares	60%
(c) To applicant of 3,000 shares	NIL

The final call was not made, All amount due were received expect that the call on 100 share was not received. Give Journal Entries, Leger Account and Balance Sheet.

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Solution: Journal Entries in the books of Trichy National Cotton Mills Limited

Date	Particulars	L.F	Dr.	Cr
	Bank A/c Dr To Equity share Application a/c (being the application money on 15,000 shares at Rs.2/- per share received		30,000	30,000
	Equity Share Allotment Dr To Equity Share Capital a/c (being the application money on 10,000 shares transferred top Share capital)		20,000	20,000
	Equity Share Allotment Dr To Equity Share Capital a/c (being the allotment money due on 10,000 shares at Rs.3/- per share)		30,000	30,000
	Equity Share Application a/c Dr To Equity Share Capital a/c (being the allotment money on 3,000 shares refunded due to rejection)		6,000	6,000
	Equity Share Application a/c Dr To Equity Share Allotment a/c (being the surplus application money on 2,00 shares transferred to Shares allotment a/c due to partially accepted application)		4,000	4,000
	Bank a/c Dr To Equity Share Allotment a/c (being the amount due on allotment i.e Due Rs.30,000 minus Rs.4,000 adjusted now received)		26,000	26,000
	Equity Share I Call a/c Dr To Equity Share Capital a/c (being the first call money due on 10,000 shares at Rs.3/- per share)		30,000	30,000
	Bank a/c Dr To Equity Share I Call a/c (being the first call money duly received except on 100 shares Rs.3/- per share)		29,700	29,700

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Bank A/c

Dr. Cr.

	Rs.		Rs.
To Equity Share Application A/c	30,000	By Equity Share Application A/c	6,000
To Equity Share Allotment A/c	26,000		
To Equity Share I Call A/c	29,700	By Balance b/d	79,700
	85,700		85,700
To balance b/d	79,700		

Equity Share Application A/c

Dr. Cr.

	Rs.		Rs.
To Equity Share Capital A/c	20,000	By Bank A/c	30,000
To Bank A/c	6,000		
To Equity Share Allotment A/c	4,000		
	30,000		30,000

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Equity Share Allotment A/c

Dr. Cr.

	Rs.		Rs.
To Equity Share Capital A/c	30,000	By Equity share Application A/c	4,000
		By Bank A/c	26,000
	30,000		30,000

Equity Share First Call A/c

Dr. Cr.

	Rs.		Rs.
To Equity Share Capital A/c	30,000	By Bank A/c	29,700
		By Balance b/d	300
	30,000		30,000
To Balance b/d	300		

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Equity Share Capital A/c

Dr. Cr.

	Rs.		Rs.
To Balance c/d	80,000	By Equity Share Application A/c	20,000
		By Equity Share Allotment A/c	30,000
		By Equity Share I Call A/c	30,000
	80,000		80,000
		By Balance b/d	80,000

In the balance sheet of Joint Stock Company, the calls - in - arrears are deducted from Share Capital. Then, the number of share and the amount in respect of shares should be exhibited in connection with share capital.1. Authorized, 2.Issued, 3. Subscribed and paid-up-Capital

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Balance Sheet of Trichy National Cotton Mills Ltd as at ...

Liabilities	Rs.	Rs.	Assets	Rs
Share Capital :				
Authorized - 20,000 Equity Share of Rs. 10/- each	2,00,000		Bank Balance	79,700
issued - 10,000 Equity Share of Rs.10/- each	1,00,000			
Subscribed & Paid up 10,000 Equity Share of Rs.10/- each, Rs.8/- called – up	80,000			
Less Calls in arrear	300	79,700		
		79,700		79,700

Working Notes	Due Rs.	Received Rs.
On application Rs. 2 x 15,000 shares	-	30,000
On allotment Rs. 3 x 10,000 shares	30,000	
Rejected 3,000 x Rs. 2 = Rs. 6,000 refunded Partially Rejected		
$5{,}000 - (5{,}000 \times \frac{60}{100}) = 2{,}000 \times 2 =$ Rs. 4,000 Adjusted		26,000
On I Call Rs. 3 x 10,000 shares	30,000	
(Call In Arrear100 x 3 = 300) 30,000-300		29,700

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Illustration 3:

Jai Industries Ltd was floated with a nominal capital consisting of 20,000, 6% Preference Share of Rs.10/- each and 30,000 Equity Share of Rs.10/- each. The share capital was to be called under.

Particulars	Preference Share	Equity Share
	Rs. P	Rs. P
On Application	2.50	2.50
On Allotment	2.50	2.50
On First and Final Call	5.00	5.00

All the shares were subscribed. The final call on 400 Equity Shares was not received. You are asked to show the record of the above transferred in the Company's Cash book and Journal. Exhibit the balance Sheet of the Company.

Cash Book

Dr. Cr.

	Rs.		Rs.
To Preference Share Application A/c	50,000	By balance c/d	4,98,000
To Equity Share Application A/c	75,000		
To Preference Share Allotment A/c	50,000		
To Equity Share Allotment A/c	75,000		
To Preference Share first and final call A/c	1,00,000		
To Equity Share First and Final Call A/c	1,48,000		
	4,98,000		4,98,000
By Balance b/d	4,98,000		

Solution: Journal Entries in the books of Jai Industries Limited.

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Date	Particulars	Dr.	Cr
	Preference Share Application A/c Dr To Equity share capital A/c (being the application money transferred to Share Capital A/c)	50,000	50,000
	Equity Share Application A/c Dr To Equity share capital A/c (being the application money transferred to Share Capital A/c)	75,000	75,000
	Pref. Share Allotment A/c Dr To Pref. Share Capital A/c (being the allotment money on 20,000 pref. Share at Rs.2.50 per share due as per Board's Resolution dated)	50,000	50,000
	Equity Share Allotment A/c Dr To Equity Share Capital A/c (being the allotment money due on 30,000 Equity Share at Rs.2.50 per share due as per Board's Resolution dated)	75,000	75,000
	Preference Share I & Final Cal A/c Dr To Preference Share Capital A/c (being the first and final call money due on 20,000 Pref. Share at Rs.5/- per share as per Board's Resolution dated)	1,00,000	1,00,000
	Equity Share I and Final Call A/c Dr To Equity share capital A/c (being the first and final call money due on 30,000 Equity share Rs.5/- per share as per Board's resolution dated)	1,50,000	1,50,000

Working Notes: Authorized @ Rs. 10/- @ Rs. 10/-
20,000 30,000

Rs	Preference Share		Equity Share	
	Due Rs.	Received Rs.	Due Rs.	Received Rs.
On Application Rs. 2.50	-	50,000	-	75,000
On Allotment Rs. 2.50	50,000	50,000	75,000	75,000
On First and Final Call Rs.5.00	1,00,000	1,00,000	1,50,000	1,48,000
Calls in arrear	-	-	-	2,000

(N.B: The above Cash Book shows bank column and Cash book transactions need not be journalized, since Cash book itself is a Journal)

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Balance Sheet of Jai Industries Ltd.

Liability	Rs.	Rs.	Assets	Rs.
Share Capital :				
Authorized - 30,000 Equity Share of Rs. 10/- each		3,00,000	Bank Balance	4,98,000
20,000, 6% Preference Share of Rs.10/- each		2,00,000		
issued Subscribed & Paid up				
30,000 Equity Share of Rs.10/- each fully called	3,00,000			
20,000, 6% Preference Share	2,000	2,98,000		
of Rs. 10/- each full called and paid	2,00,000			
		4,98,000		4,98,000

What is meant by premium?

The amount that something in scarce supply is valued above its nominal value

6.4.1 AT PREMIUM

A company which is likely to be very successful or an existing well established successful company asks people to pay more than the face value of he shares. Suppose, a company asks people to pay Rs.12 for every share of Rs.10. When shares are issued at a price higher than the face value of the shares, it is said that shares, it is said that shares are issued at a premium. Here the difference Rs.2/- represents premium. The premium amount is a profit of the company. But this is not a trading profit; it is the nature of special receipt for the company.

There are no legal restrictions upon the issue of shares at a premium but section 78 of the Indian Companies Act puts certain restrictions on the disposal of such premium. The premium amount should be credited to a separate account called

'Share Premium Account'. This should not be distributed as dividend. However, this amount can be utilized by the company for the following purposes.

I) For the issue of Bonus Shares to the members of the company.

ii) For writing off preliminary expenses.

iii) For writing off the Issue expenses or commission or discount on the issue of shares and debentures.

If the company wants to dispose of the share premium for any other purpose, sanction of the court will be necessary. Usually, the share premium is payable on allotment, it may be collected along with application or first call or second call, as the company may wish.

Illustration: 4

Mani Ltd invited applications for 10,000 shares of Rs.10 each Rs.12. The payment was to be received. On application Rs.3 On allotment Rs. 5 (including premium) On call Rs.4.The public applied for 10,000 shares. Allotment was made journalize the transactions and prepare the balance sheet assuming that all the moneys due were received.

Hints

On application	Rs. 3	x	10,000 =	Rs. 30,000	Due & Received
On allotment	Rs. 3	x	10,000 =	Rs. 20,000	,,
On premium	Rs. 2	x	10,000 =	Rs. 20,000	,,
On call	Rs. 4	x	10,000 =	Rs. 40,000	,,

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Balance Sheet of Mani Ltd

Liability	Rs.	Assets	Rs
Share Capital Authorized :		Bank balance	1,20,000
Issued Subscribed Paid up :			
10,000 Shares of Rs. 10/- each	1,00,000		
Share Premium Account	20,000		
	1,20,000		1,20,000

Solution: Journal Entries In the books of Mani Limited

Date	Particulars	Dr.	Cr
	Bank A/c Dr To Share Application A/c (being the application money on 10,000 Shares at Rs.3/- per shares received)	30,000	 30,000
	Share Application A/c Dr To Share Capital A/c (being the allotment money due on 10,000 shares at Rs.3/- per share as per Board's Resolution dated)	30,000	 30,000
	Bank A/c Dr To Share Allotment A/c To Share Premium A/c (being the allotment money and share premium duly received on 10,000 share at Rs.3/- and Rs.2/- per shares respectively)	50,000	 30,000 20,000
	Share Final Call A/c Dr To Share Capital A/c (being the final call due on 10,000 shares at Rs.4/- per share as per board's dated)	40,000	 40,000
	Bank A/c Dr To Share Final Call A/c (being the final call money duly received)	40,000	 40,000

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6.4.2 AT DISCOUNT

No new company can issue shares at a discount (i.e. for a price less than the face value of the shares). An existing company can issue shares at a discount only under certain conditions. No new class of shares can be issued at a discount. That is the shares to be issued at a discount must be a class which has already been issued by the company. The discount rate must not exceed 10 percent. At least one year must have lapsed after the commencement of business. Such an issue must be authorized by a resolution passed in the general body meeting and must be sanctioned by the court. The issue of such shares must take place within 2 months from the date of court's sanction (Section 79 of the Companies Act).

What is discount?

A reduction in the selling price of something

Illustration: 5 **(Discount on Issue of Shares)**

Kingfisher Ltd Having complied with provisions of Section 79 of the Indian companies Act 1956 issue 10,000 Equity shares of Rs.100 each at a 5% discount. These were all subscribed and paid for in full. Make Journal and Balance Sheet entries.

Working Notes

		Rs.
Face Value = Rs. 100 x 10,000 Shares	=	10, 00,000
Issued at 5% Discount = $10,000 \times \frac{5}{100}$		
= Rs. 5 Loss on 10,000 shares	=	50,000
Balance received	=	9, 50,000

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Solution: Journal Entries in the books of Kingfisher Limited

Date	Particulars	L.F	Dr.	Cr
			Rs.	Rs.
	Bank A/c		9,50,000	
	Discount on Issue of Shares A/c		50,000	
	To Equity Share Capital A/c			10,00,000
	(being the amount received on the issue of 10,000 Shares at Rs.100 each at Rs.95)			

Balance Sheet of Kingfisher Ltd

Liabilities	Rs.	Assets	Rs.
Share Capital Authorized Issued Subscribed & Paid up		By Bank Balance Discount on issue on shares	9,50,000 50,000
10,000 Equity shares of Rs. 100 each fully paid	10,00,000		
	10,00,000		10,00,000

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6.4.3 CALLS IN ADVANCE

Sometimes, some share holders may be willing to pay all or the portion of the money due from them on their shares before the money is actually called by the directors. Their desire is not to be troubled by future calls. If the directory think fit, they may receive such money in advance and credit there on to the shareholders at such a create as provided in the Articles of Association. When the call is actually made, the amount is transferred by means of a journal Entry from the Calls is Advance A/c to the particular call A/c. Legally, paid in Advance do not from part of Paid up share capital of a company and, therefore are shown as a separate item on the liabilities side of the Balance Sheet.

6.4.4 FORFEITURE & SURRENDER OF SHARES

What is forfeiture?

A penalty for a fault or mistake that involves losing or giving up something

When a person applies for shares in a company, he binds himself to pay in time all the calls made by the company. If a member does not pay calls, the directors have a right to charges interest according to the Articles of Association. It if is silent, Table A allows upto 5 percent interest to be charged. However, if a member does not pay at all, the directors have a right to forfeit his share (i.e) to deprive the member of his shares and to re-sell them to some other person. Before doing this, 14 days notice must be given to the member. If the member still does not pay the call, his shares will be forfeited as per Board's Resolution and the member will be informed accordingly. The effect is the cancellation of the shares, in case of surrender of shares, the member

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himself voluntarily gives up his shares but the effect is the same. Suppose a company has issued 10,000 of 10/- each. All the moneys duly received except one shareholder holding 1,000 shares on which Rs.8/- per share called up. He did not pay the First call of Rs. 2/- and Second call of Rs.3/-. The company forfeited the shares. The entry will be.

	Rs.	Rs.
Share Capital A/c Dr.	8,000	
To Share I Call A/c		2,000
To Share II Calls A/c		3,000
To Share Forfeiture A/c		3,000

(Being the forfeiture of share son which both I & II call have not been received)

Take Note

To cancel the shares, Shares Capital A/c is debited with the amount already called up (Rs.8) and not the face value (Rs.10) of share. Credit the Calls A/c for nonpayment. The amount already paid by the member (Called up Rs.8, First Call Rs.2 + II Call Rs.3, unpaid Rs.3) is credit to Share Forfeiture A/c which will appear as an item on the Liabilities side of the balance sheet since it is an item of Capital Profit.

Balance Sheet (Rough)

Liabilities	Rs	Assets	Rs
9,000 Share of Rs.10/- each Rs.8/- called up	72,000	Bank Balance	75,000
Share Forfeitures A/c	3,000		
	75,000		75,000

Re - Issue of Forfeited Share

Forfeited shares can also be re-issued by the directors. They can be issued at a discount (i.e) at a price lower than the paid up value. But the discount (loss) must not exceed the amount actually received already on such forfeited shares. Counting the previous example, the above noted 1,000 shares are issued at Rs.6 per share. It means that there is a loss of (Rs.8 - Rs.6 = Rs.1 x 1,000) Rs.2, 000. This loss will be debited to Share Forfeiture A/c. On re-issue, the entry will be:

		Rs.	Rs.
Bank A/c	Dr.	6,000	
Shares Forfeiture A/c	Dr.	2,000	
To Share Capital A/c			8,000

(being the re-issue of 100 forfeited shares as Rs.8 paid up at Rs.6 per share)

The profit left after the re-issue of shares Rs.1,000 (Rs.3,000 - Rs.2,000) in this case will be transferred and credited to capital Reserve Account. This will happen, if all the forfeited shares have been re-issued. Obviously, the shares Forfeiture A/c gets debit for this. It may be used for writing off Fictitious Assets like Goodwill, Preliminary Expenses etc but it should not be used for declaring dividend.

NOTES

Share Forfeiture A/c Dr. 1,000

To capital Reserve A/c 1,000

(Being the balance of Forfeiture share A/c transferred to Capital Reserve A/c)

After the re-issue of share, the Balance sheet will appear as follows.

Balance Sheet (Rough)

Liabilities	Rs.	Assets	Rs
10,000 Share of Rs.10/- each Rs.8/- called up	80,000	Bank (Rs. 75000 + 6000)	81,000
Capital Reserve	1,000		
	81,000		81,000

Capital Reserve will appear on the liabilities side of the balance sheet. If some forfeited shares remain unissued the forfeited amount, in respect of such shares should remain in the shares forfeiture A/c

NOTES

Illustration: 6 give the accounting entries in the case of 100 equity shares Rs.10 of each Rs.5 per share called up and Rs.4 per share paid up forfeited and re-issued as fully paid for Rs.7 each.

Solution **Journal Entries**

Date	Particulars		Dr.	Cr
	Equity Share Capital A/c	Dr	500	
	To Unpaid Call A/c			100
	To Share Forfeiture A/c			400
	(being the forfeiture of 100 shares Rs.5 called up and amount not received there on as Rs.1)			
	Bank A/c	Dr	700	
	Share Forfeiture A/c	Dr	300	
	To Equity Share Capital A/c			1,000
	(being the re-issue of 100 forfeited shares at Rs.7 each as fully paid)			
	Share Forfeiture A/c	Dr	100	
	To Capital Reserve A/c			100
	(being the balance of share forfeited A/c transferred to Capital reserve A/c)			

NOTES

Illustration: 7

Mr. A hold 100 shares of Rs.10 each on which he has paid Rs.1 per share as application money. Mr. B hold 200 shares of Rs.10 each and has paid Rs.1 and Rs.2 as Application and Allotment and Rs.3 per share for the First Call. Mr. C holds 300 share of Rs.10 each and has paid Rs.1 on Application Rs.2 Allotment and Rs.3 per share for the First Call. They all fall to pay their arrears and the Final call of Rs.4 per share and Directors, therefore their shares. These shares are subsequently, re-issued for cash at a discount of 10 percent.

* Pass the Journal Entries in the books of the Company to give effect to the above State also in what manner the amount if any, standing to the credit of Share forfeiture A/c can be utilized.

Holding (Shares)	So for Paid (Rs)				Arrears (Rs)			
	Application	Allotment	I Call	Final call	Application	Allotment	I Call	Final Call
Mr.A-100	100					200	300	400
Mr .B-200	200	400	600					800
Mr.C-300	300	600	900					1200
Total-600	600	1000	1500	200	300	2400		

Rs. 6,000 Rs. 3,100
Capital to be cancelled to be forfeited
Rs. 6,000 capital reissued at 10% discount.

$6,000 \times \frac{10}{100}$ = Rs. 600 loss to be adjusted against Share Forfeiture A/c.

NOTES

Solution: Journal Entries in the books of X company Limited

Date	Particulars	L.F	Dr.	Cr
			Rs.	Rs.
	Share Capital Dr		6,000	
	To Share Allotment A/c			200
	To Share I Call A/c			300
	To Share Final Call A/c			2,400
	To Share Forfeiture A/c			3,100
	(Being the forfeiture of 600 shares at Rs.10 per share fully called up. Amount due but not received)			
	Bank A/c Dr		5,400	
	Share Forfeiture A/c Dr		600	
	To Share Capital A/c			6,000
	(Being the re-issue of 100 for forfeited shares at Rs.10 per share at a discount of 10%)			

The amount standing in the credit of Forfeiture shares A/c Rs.2,500 may be transferred to Capital Reserve A/c. Since all the forfeited shares have been re-issued Or it may be utilized writing off Preliminary Expenses. Goodwill or other fictitious asset. But, it is not available for dividend.

N.B:

1) If Shares issued at a premium have to be forfeited, it should not debit the share premium A/c. The share premium account should remain intact.

2) If shares issued at a discount have to be forfeited, it would be better the discount on such shares to the discount on Issue of Share A/c. This will ensure that the balance in this account will be in proportion to the Share Capital. If later, these shares are re-issued then the requisite amount should again be debited to the Discount on issue of Shares A/c.

NOTES

Illustration: 8

Mythili Limited issued its prospectus inviting application for 20,000 shares of Rs.10 each at a premium of Rs.2 per payable as follows. Rs.2 on application, Rs.6 on allotment (including premium) Rs.2 on first call Rs.2 on final call. Application for 30,000 shares were received Applicants for 5,000 shares were not allotted any shares and money was refunded. The remaining applicants were allotted 20,000 shares and money overpaid on application was used towards payment on allotment. All calls were made. Money was realized from all share holders except one who was allotted 200 share and who failed to pay the two calls. His shares were forfeited and later re-issue for Rs.8 per share. Give journal entries in the books of the company.

NOTES

Solution: Journal Entries in the books of Mythili Limited

Date	Particulars	L.F	Dr.	Cr
	Bank A/c Dr To Share Application A/c (being 30,000 applications received)		60,000	 60,000
	Share Application A/c Dr To Bank A/c (being 5,000 applications rejected)		10,000	 10,000
	Share Application A/c Dr To Share Capital A/c To Share Allotment A/c (being 20,000 share allotted for 25,000 applications and the balance adjusted on allotment A/c)		50,000	 40,000 10,000
	Share Allotment A/c Dr To Share Capital A/c To Share Premium A/c (being 20,000 shares allotted including premium of Rs.2 per shares)		1,20,000	 80,000 40,000
	Bank A/c Dr To Share Allotment A/c (being the Allotment money received)		1,10,000	 1,10,000
	Share First Call A/c Dr To Share Capital A/c (being the share first call made)		40,000	 40,000
	Bank A/c Dr To Share First call A/c [being the first call money received Rs.39,600 (40,000 - 40)]		39,000	 39,000
	Share Final Call Account A/c Dr To Share Capital A/c (being the final call made)		40,000	 40,000
	Bank A/c Dr To Share Final Call A/c [being final call money received Rs.39,600 (40,000-40)]		39,600	 39,600
	Share Capital A/c Dr To Share First Call A/c To Share First Call A/c To Share Forfeiture A/c (being 200 shares forfeited and the unpaid calls adjusted and the balance transferred to Forfeiture A/c)		2,000	 400 400 1,200
	Bank A/c Dr Share Forfeiture A/c To Share Capital A/c (being the forfeited share re-issued at Rs.8 per share)		1,600 400	 2,000
	Share Forfeiture A/c Dr To Capital Reserve A/c (being the balance in forfeiture A/c transferred to Capital Reserve A/c)		800	 800

NOTES

Illustration 9

Vijay Limited issued for public subscription 20,000 equity shares of Rs. 10 each at a premium of Rs. 2 per share payable as under:

On application	-	Rs. 2 per share.
On allotment	-	Rs. 5 per share
On first call	-	Rs. 2 per share
On second call	-	Rs. 3 per share

Applications were received for 30,000 shares. Allotment was made pro-rata to the applicants for 24,000 shares, the remaining applications were refused Money over paid on application was utilized towards sums due on allotment.

Arun, to whom 800 shares were allotted, failed to pay allotment and calls money and Babu to whom 1,000 shares were allotted failed to pay the two calls. These shares were subsequently forfeited after the Second call was made all the forfeited shares were sold to Chandran as fully paid up at Rs. 8 per share.

Show the Journal entries in the books of Vijay Ltd.

NOTES

Books of Vijay Ltd.Journal entries

Date	Particulars	L.F.	Debit Rs.	P.	Credit Rs.	P.
	Bank A/c Dr. To Share Application A/c (For application money @ Rs.2 received on 30,000 shares)		60,000	-	60,000	-
	Share Application A/c Dr. To Share Capital A/c (For Application @ Rs.2 each on 20,000 shares credited to share capital A/c)		40,000	-	40,000	-
	Share Application A/c Dr. To Share Allotment A/c To Bank A/c (For transferring application money to allotment account and return of rejected application money)		20,000	-	8,000 12,000	- -
	Share Allotment A/c Dr. To Share Capital A/c To Securities Premium A/c (For amount due on allotment Rs.5 (Rs.3 for capital and Rs.2 for premium) on 20,000 shares allotted)		1,00,000	-	60,000 40,000	- -
	Bank A/c (See W.N.I) Dr. To Share Allotment A/c (For receipt of allotment money except on Arun's shares)		88,320	-	88,320	-
	Share First Call A/c Dr. To Share Capital A/c (For Share First Call money due on 20,000 shares @ Rs.2 each)		40,000	-	40,000	-
	Bank A/c Dr. To Share First Call A/c (For receipt of first call money except on shares of Akbar and Babu)		36,400	-	36,400	-
	Share Second Call A/c Dr. To Share capital A/c (For amount due on final call @ Rs.3 per share on 20,000 shares)		60,000	-	60,000	-
	Bank A/c Dr. To Share second call A/c (For receipt of second call money on 18,200 shares @ Rs.3 per share)		54,600	-	54,600	-
	Share Cap A/c (1,800x10) Dr. Share Premium A/c Dr. To Share Allotment A/c To Share First call A/c (1800x2)To Share Second call A/c (1800 x 3) To Forfeited shares A/c (bal.fig) (For Forfeiture of 1,800 shares (both Arun & Babu's shares) for nonpayment of allotment and call money)		18,000 1,600	- -	3,680 3,600 5,400 6,920	- - - -
	Bank A/c Dr. Forfeited Shares A/c Dr. To Share capital A/c (For reissue of 1,800 forfeited shares @ Rs.8 per share)		14,400 3,600	- -	18,000	-
	Forfeited Shares A/c Dr. To Capital Reserve A/c (6,920 – 3,600) (For profit on reissue of 1,800 shares transferred to capital reserve)		3,320	-	3,320	-

NOTES

Working Note:

(1) Calculation of amount received on allotment:

Amount due on allotment (20,000 x 5)	1,00,000
LESS: Surplus money on application adjusted to share allotment	8,000
	92,000
LESS: Amount not received on 800 shares allotted to Akbar:	
If allotted 20,000; shares applied	24,000
	78,000
If allotted 800; share applied	960
Surplus money on application (160 x 2) =	320
Therefore, Amount due on allotment (800 x 5) =	4,000
Less: Surplus on application	320
Amount received on allotment	3,680
	88,320

6.5 UNDERWRITING

NOTES

In selling the shares and debentures there is a risk on the part of the company that the number of shares or debentures offered for subscription may not be taken up by public. Underwriters are firms which undertake the responsibility that the shares and debentures issued by the company will be taken up by the public. If these are not taken up by the public, the underwriters will have to take them up. If the public takes up the whole issue, the under writers will have liability.

For this guarantee, the underwriters get commission. According to the provisions in the Indian Companies Act. Underwriting commission cannot exceed. 2½% of the Issue of debenture and 5% of the Issue price of shares, When underwriting commission is payable the following entry will be passed

Commission on issue of A/c Dr

To Underwriter's A/c

(Being the Underwriting Commission payable)

Those applications which are received through the underwriters (with their stamp marks) are known as Marked Applications. Those applications which do not bear the stamp of the underwriter are known as Unmarked Applications. If there is only one underwriter who has underwritten the whole issue, it does not major whether these applications are marked or unmarked. The reason is that he will be given commission for all applications whether sent through him or directly. It doesn't

NOTES

matter, if there are two or more the issue has been only partially underwritten. Underwriting Commission and Discount on issue of Shares and on debentures are losses. As such, these two accounts may be transferred to Cost on issue of Debentures or share A/c

* Underwriting means insurance and so underwriting of shares or debentures is an insurance against short subscription.

Illustration: 10

Unisoft Limited Issued 1,000 Equity shares of Rs.100 each of Rs.96. The issue was underwriting by Mr.Ashok for the maximum commission allowed by law. The public applied for and allotted 900 shares, the whole payment being received immediately give journal entries and balance sheet. The underwriters fulfilled their obligation.

Solution: Journal Entries in the books of Unisoft Limited

Date	Particulars	L.F	Dr.	Cr
	Bank A/c Dr Discount on Issue of Share A/c Dr To Equity Share Capital A/c (Being the issue of 900 shares Rs.100 at Rs.96 per share)		86,400 3,600	 90,000
	Goodwill A/c Dr Discount on Issue of Share A/c To Equity Share Capital A/c (Being the allotment of 100 shares not applied for by the public to the underwriter at Rs.96 per share)		9,600 400	 10,000
	Commission on Issue of Shares A/c Dr To Goodwill A/c (Being the underwriting commission on the issue of 1,000 shares Rs.96,2.5 % payable)		2,400	 2,400
	Bank A/c Dr To ashok A/c (being the balance amount 9,600 - 2,400 due from Ashok received)		7,200	 7,200
	Cost on Issue of Shares A/c Dr To Discount on Issue of Share A/c To Commission on Issue of Share A/c (being the latter accounts transferred to cost on Issue of shares A/c)		6,400	 4,000 2,400

Unisoft Ltd Balance Sheet As At...

Liabilities	Rs.	Assets	Rs.
Equity Share Capital	1,00,000	Bank	93,600
		Cost on Issue of Shares	6,400
	1,00,000		1,00,000

Illustration: 11 (Underwriters - More than one partially underwritten)

PQR Co Ltd. Formed with a capital of Rs.1, 00,000 on Rs.100 share the whole amount being issued to the public. The Underwriting was as follows.

K	100	L	30	M	200
N	350	X	200	Y	300

All marked forms were to go in relief of the underwriters whose names they bear. The applications on forms marked by the underwriter were :

K	75	L	50	M	200
N	220	X	Nil	Y	225

NOTES

Application for 130 shares was received on forms not "marked". Draw up a statement showing the number of shares each underwriter had to take up.

Solution

Statement showing the number of shares each underwriter had to take up

	K	L	M	N	X	Y
Gross	100	30	200	350	20	300
Less : Unmarked applications in the ratio of Gross Liability	13	4	26	45	3	39
	87	26	174	305	17	261
Less : Marked forms	75	50	200	220	Nil	225
Net Liability	+12	+24	+26	85	17	36
Surplus of L and M distributed among others in ratio of 100:350:300	-7	-24	-26	23	1	19
Shares to be acquired under the agreement	5	...	...	62	16	17

NOTES

6.6 REDEMPTION OF PREFERENCE SHARES

After the commencement of the Companies Act 1956 only two types of shares are permitted or issue. They are 1. Equity Share and 2. Preference Share.

A Share which is not a preference Share is an Equity Share, A preference share is one which has a preferential right in respect of a fixed dividend and a preferential right to repayment of capital at the time of winding up of the company. If the Articles of Association of a company permits, it can use the following types of Preference Shares carrying additional rights.

1. Cumulative Preference shares carry an additional right to claim such arrears of dividend if the directors do not declare a dividend in a particular year on account of insufficiency of points. If is not Non-Cumulative Preference Share if for any years dividend not paid. The right to receive that dividend for that year lapses.

2. Participating preference share carry an additional right to participate in the Surplus profit over the fixed preferential dividend.

3. Guaranteed Preference share carry a fixed dividend guaranteed by vendors, even if the profits in a particular year are insufficient to pay their dividend.

NOTES

4. Convertible preference shares carry additional rights to convert them into Equity Shares within a certain period. If there is no such right it is called no convertible preference shares.

5. Redeemable Preference Shares are those that are issued on condition that they will be redeemed on some future date on at any time at the option of the company. We shall make a detailed discussion about Redeemable Preference Shares.

Normally, no company is allowed to repay the amount of share capital, unless the company is wound up. Several restrictions are imposed by law on the issue and redemption of Redeemable Preference Shares. Of course, the fact of the issue of such shares has to be disclosed in the prospectus at the time of issue and the terms have to be adhered to further the redemption of preference shares is subject to the following provisions (sec 80 of the Act)

1. They cannot be redeemed unless they are fully paid.
2. Redemption can be carried out either out of profits or out of the proceeds of fresh issue of shares made for this purpose, (they can be redeemed partly out of profits and partly out of the proceeds of the new issue of shares)
3. If they are redeemed out of profits a sum equal to the face value of the shares so redeemed must be transferred to "Capital Redemption Reserve A/c" by debiting P & L, A/c and or Reserve built out of profits.
4. Premium if any payable on redemption of Preference Shares must be provided only out of the profits or out of Shares premium A/c.

NOTES

5. Capital Redemption Reserve A/c can be used by the company to issue fully paid bonus $ Shares otherwise, the account must be kept in fact Court sanction will be necessary to use this account.

As a result of redemption what happens is that money is paid to Redeemable Preference Shareholders. But the money must have been collected either through profits or by issue on new shares. That means in stand of one set of shareholders is replaced by another a suitable portion of funds is permanently kept back out of profits by transfer for capital Redeemable Preference A/c. This is not available to dividend.

* It includes Reserve built out of past profits.$ In the case of a successful company, large reserve might have been accumulated out of profits as a result of a policy not to distribute the whole of the profits. At a later data, instead of paying cash and depicting the financial resources, the company, may capitalize the profits by issuing Bonus shares to the share holders who received them free of cost.

Illustration: 12. A company in a series of operations

i) Issue at par 2, 00,000 Redeemable Preference Shares of Rs.10 each redeemable at a premium of Rs.2 per share.

ii) Redeems 1, 00,000 of the Redeemable Preference Shares out of the profits of the company.

iii) Issues at par 2, 00,000 Equity Shares of Rs.20 each and out of the proceeds redeem the balance of the Redeemable Preference Shares.

Journalize the above transactions.

NOTES

Solution: Journal

Date	PARTICULARS	Dr.	Cr
(i)	Bank A/c Dr To Redeemable Preference Share Capital A/c (being the issue of 2,00,00 redeemable preference shares of Rs.10 each)	20,00,000	20,00,000
(ii)	Profit and Loss A/c Dr To Premium on Redeemable A/c (being the provision of premium of Rs.2 per share payable on redemption on 1,00,000 redeemable preference shares)	2,00,000	2,00,000
	Profit and Loss A/c Dr To Capital Redeemable Share (being the transfer of the request sum from P & L A/c on the redemption of 1,00,000 redeemable preference shares of Rs.10 each)	10,00,000	10,00,000
	Redeemable Pref. Shares Capital A/c Dr Premium on Redemption A/c Dr To Redeemable Pref. Shareholders A/c (being the transfer of the amounts due on redemption of 1,00,000 redeemable preference shares)	10,00,000 2,00,000	12,00,000
	Redeemable Pref. Shareholders A/c Dr To Bank A/c (being the redemption 1,00,000 redeemable preference shares at a premium of Rs.2 per shares)	12,00,000	12,00,000
(iii)	Bank A/c Dr To Equity Shares Capital A/c (being the issue of equity shares 2,00,000 at Rs.10 each share)	20,00,000	20,00,000
	Profit and Loss A/c Dr To Premium on Redemption A/c (being the premium on redemption provided for out of profits before redemption)	2,00,000	2,00,000
	Redeemable Pref. Shares Capital A/c Dr Premium on Redemption A/c Dr To Redeemable A/c (being the transfer of amounts due on redemption of 1,00,000 redeemable preference shares)	10,00,000 2,00,000	12,00,000
	Redeemable Pref. Shareholders A/c Dr To Bank A/c (being the redemption of the balance of 1,00,000 redeemable preference share at premium of Rs.2 per shares)	12,00,000	12,00,000

Illustration: 13. On 31^{st} December 2009 the balance sheet of Make Believe Ltd was as under:

LIABILTIES	Rs.	ASSETS	Rs.
2,000 Equity shares of Rs.100 each	2,00,000	Sundry Assets	9,00,000
3,000, 6% Redeemable preference shares of Rs.100 each	3,00,000	Bank	1,00,000
6% Debentures	1,00,000		
General Reserve	1,50,000		
Profit and Loss A/c	1,00,000		
Sundry Creditors	1,50,000		
	10,00,000		10,00,000

Redeemable Preference Shares were redeemed on the above date at Rs.105 and for this purpose 1,000 equity Share were issue at Rs.150. All these shares were taken by the public. Give Journal Entries and Show the Balance Sheet.

NOTES

Solution Journal

Date	PARTICULARS	Dr.	Cr
2009	Bank A/c Dr To Equity Share A/c To Share Premium A/c (being the issue of 1,000 equity shares at Rs.150)	1,50,000	 1,00,000 50,000
	Profit and Loss A/c Dr To Premium on Redemption A/c (being premium on redemption provided for out of profit before redemption)	15,000	 15,000
	6% Redeemable Preference A/c Dr. Premium on Redemption A/c Dr. To 6% Redeemable Preference Shareholders A/c (being the transfer of amount due on redemption of 3000, 6% redema to the redeemable preference shareholders)	3,00,000 15,000	 3,15,000
	General Reserve A/c Dr. Profit and Loss A/c Dr. To Capital Redemption Reserve A/c (being the amount transferred to capital Redemption Reserve Account (i.e) Rs. Value of shares redeemed 3,00,000 Less Face value of new shares issued 1,00,000 2,00,000	1,50,000 50,000	 2,00,000

* When Share Premium is available, that can be used under section 78 and 80 of the Companies Act for the purpose instead of making a provision out of profits.

	6% Redeemable Preference Shareholders A/c Dr. To Bank A/c (being the liability discharged by getting overdraft arrangement with the bank for Rs.85,000 i.e Actual bank balance is 1,00,000 + Share Subscription 1,50,000		3,15.000	 3,15.000

NOTES

Make Believe Ltd Balance Sheet as at 31st December 2009

Liabilities	Rs.	Assets	Rs.
Share Capital :		Sundry Assets	9,00,000
Authorized issued subscribed			
and paid up 3,000 Equity			
Share of Rs.100 fully called			
Up and paid	3,00,000		
Reserve and Surplus :			
Capital Redemption Reserve A/c	2,00,000		
Share Premium A/c	50,000		
Profit and Loss A/c	35,000		
Secured Loans :			
6% Debentures	1,00,000		
Bank O/D	65,000		
Current Liabilities & Provisions :			
Sundry Creditors	1,50,000		
	9,00,000		9,00,000

NOTES

What are debentures?

A certificate or voucher acknowledging a debt

6.7. ISSUE OF DEBENTURES

6.7. 1 INTRODUCTION

Shares are uniform parts of capital. Just as shares, debentures are issue on the basis of prospectus. The public invited to purchase them. They will apply for debentures are issued on the basis of prospectus. The public invited to purchase them. They will apply for debentures just they apply for shares. The directors will consider and make the allotment after receipt of applications. Accounting entries (Journal) are similar in both the cases. The student must remember to use term 'Debentures' instead of the term 'Shares' in his entries. Debentures will appear on the Liabilities side of the Balance Sheet.

Illustration: 1

(Debentures Issued)

Sure Ltd issued 3,000, 6% Debentures of Rs.100 each payable at Rs.20 on application and remaining amount on allotment. The public applied for 2,000 debentures and the same was allotted. Journal entries are required. Show also the Balance Sheet.

Working Notes: Issued .... 3,000 Debentures

Applied & Allotment 2,000

On Application Rs. 20 x 2000 = Rs. 40,000

Balance (Rs. 100-20) Rs. 80 on allotment Rs. 80 x 2000 = Rs.1, 60,000

NOTES

Solution: **Journal of Sure Ltd**

Date	Particular	Dr.	Cr
	Bank A/c Dr To Debenture Application A/c (being the application money received on 2000 debentures at Rs.20 per debenture)	40,000	40,000
	Debenture Application A/c Dr To Debentures A/c (being the application money transferred to debentures A/c)	40,000	40,000
	Debenture Allotment A/c Dr To Debentures A/c (being the application money due on 2000 debentures at Rs.80 per debentures)	1,60,000	1,60,000
	Bank A/c Dr To Debenture Allotment A/c (being the allotment money duly received)	1,60,000	1,60,000

* Similar entries are passed when further calls are made and cash received.

Sure Ltd Balance Sheet As At ....

Liabilities	Rs.	Assets	Rs.
6% Debentures	2,00,000	Bank	2,00,000
	2,00,000		2,00,000

NOTES

Suppose 2,000 debentures of Rs.100 each are allotted to people who pay the whole amount in lump sum. The entry this

Bank A/c	Dr..	2, 00,000	
To Debentures A/c			2, 00,000

(Being the issue of 2,000 debentures at Rs.20 per debentures)

There are no legal restrictions as regard to terms of issue of debentures. The followings possibilities are there.

The summary entries will be as follows:

Journal of ….

Date	Particulars	Dr. Rs.	Cr Rs.
1	Bank A/c Dr To Debentures A/c (being the issue of debentures at par)	100	100
2	Bank A/c Dr Discount on issue of Debentures A/c Dr To Debentures A/c (being the issue of debentures at a discount)	95 5	100
3	Bank A/c Dr To Debentures A/c To Premium on Debentures A/c (being the issue of debentures at a premium)	105	5 100
4	Bank A/c Dr Loss on Issue Debentures A/c To Debentures A/c (being the issue of debentures at per but redeemable at a premium)	100 5	105
5	Bank A/c Dr Loss on Issue of Debentures A/c To Debentures A/c To Premium on Redemption of Debentures A/c (being the issue of debentures at a discount but redeemable at a premium)	95 5	100 5

NOTES

Note:

1. Debentures A/c is always credited with the fact value.

2. Discount on Issue of Debentures A/c is a Special Loss (These losses are shown on the asset side of the Balance Sheet will written off. They should be written off by debiting the P & L A/c (or Share Premium A/c).

3. Premium on Debentures A/c is a Capital Profit (Premium on Redemption of Debentures A/c is a liability (both are shown on the liability side of the balance Sheet)

4. Interest is always calculated on the face value of debentures under all circumstances.

S. No	Nominal (Face) Value	Issue Price	Redemption (i.e repayment price)	Base
1	Rs. 100	Rs. 100	Rs. 100	Issued at per
2	Rs. 100	Rs. 95	Rs. 100	Issued at Discount
3	Rs. 100	Rs. 105	Rs. 100	Issued at a Premium
4	Rs. 100	Rs. 100	Rs. 105	Issue at par but Redemption at premium
5	Rs. 100	Rs. 95	Rs. 105	Issued at Discount But redemption at premium

NOTES

Debentures issued As a Collateral Security

When a company borrows money form a person, say a bank it may issue its own debentures as additional) security against the loan. Such security is over and above as well as supplements the tangible security given if any. No entry is needed in the company's book of record the issue of such debentures because the company is not liable for their value of the loan is repaid in due course. After the repayment of the loan, these debentures will be returned to the company. Therefore, they merely represent a contingent liability on the company to the extent of the loan for which a note will be made in the company's Balance Sheet as below:

Liabilities	
Bank overdraft Rs. 1,00,000 (Secured by issues of Rs. 1,00,000)	

* A Collateral Security is a second security (i.e) a Security in addition of the principal or main security. Alternatively the following journal entry may be passed upon the issue of debentures as collateral security.

Debentures Suspense A/c Dr.

To Debentures A/c

If the entry is passed Debentures Suspense A/c will appear on the Asset side and Debentures on the liability side of the company's balance sheet upon redemption the above entry will be reversed as follows.

Debentures A/c Dr.

To Debentures A/c

Writing Off Loss & Discount on the Issue of Debentures

A company should write off loss and discount on the issue of debentures as quickly as possible. However there is no legal compulsion regarding this. Such losses are usually written off against the profit & Loss A/c. It may also be written off against premium on debentures or shares. The usual entry for writing off it.

Profit & Loss A/c Dr.

To Loss (Discount) on issue of Debentures A/c

(Being the loss written off)

This need not be written off in a single year. It may be spread over period of years. For example a company issued 1,000 Debentures of Rs.100 each at a discount of 6% and they are to redeemed at the rate of Rs.20,000 each year in 5 years. The total discount is Rs.6,000.

NOTES

It should be written off each year according to the ratio of the amounts outstanding. This means, that the company will use of Rs.1, 00,000 in the first year, in the next year Rs.80,000 in the third year Rs.60,000 and so on. The ratio of the amounts outstanding is as follows.

* Like Preliminary Expenses cost of issue of debentures and shares should be written off over a period usually 3 to 5 years or more.

	Rs.	
I Year	1,00,000	10 : 8 : 6 : 4 : 2
II Year	80,000	or
III Year	60,000	5 : 4 : 3 : 2 : 1
IV Year	40,000	makes a total of 15
V Year	20,000	

The discount of Rs. 6,000 is to be written off in the

I Year $= 6,000 \times \frac{5}{15} =$ Rs. 2,000

4

II Year = 6,000 x —— = Rs. 1,600

15

3

III Year = 6,000 x —— = Rs. 1,200

15

2

IV Year = 6,000 x —— = Rs. 800

15

1

V Year = 6,000 x —— = Rs. 400

15

Suppose a company issue 10,000 debentures of Rs. 100 each at a discount of 905 percent. The debentures have to be redeemed at the rate of Rs.1,00,000 each year commencing with the end of the fifth year. How can we write off this discount? The

NOTES

total discount is Rs. 95,000. The discount should be written off each year according to ratio of the amounts outstanding.

Year	Amount	Rs. Outstanding
1	10,00,000	10
2	10,00,000	10
3	10,00,000	10
4	10,00,000	10
5	10,00,000	10
6	9,00,000	9
7	8,00,000	8
8	7,00,000	7
9	6,00,000	6
10	5,00,000	5
11	4,00,000	4
12	3,00,000	3
13	2,00,000	2
14	1,00,000	1
	95,00,000 =	95

In each of the first 5 year discount to be written off will be

$$= \text{Rs. } 95{,}000 \times \frac{10}{95} = \text{Rs. } 10{,}000$$

$$6^{th} \text{ Year} = \text{Rs. } 95{,}000 \times \frac{9}{95} = \text{Rs. } 9{,}000$$

$$7^{th}\text{ Year} = \text{Rs. } 95{,}000 \times \frac{8}{85} = \text{Rs. } 8{,}000 \text{ and so on}$$

It must be remembered, that if, there is any premium on issue of debentures, the same, is available for dividend.

6.8. Redemption of Debentures

A company may decide to raise the long term capital required by it in the form of a loan against issue of Debentures in preference to raising it by issue of Shares. Whereas shareholders are Part owners of the company, debenture holders are simply creditors of the company. The interest is paid half-yearly and is a change on the assets of the company. Debentures are of various types.

Simple or Naked debentures are those which carry no charge on the revenue of the company. Mortgage Debentures are those which carry a charge on the asset of the company. When a Debenture is issued payable to bearer here of it is called a Bearer Debentures and is transferable by mere delivery. When the name of the debentures holder is entered on the debentures and on the "Register of Debentures" it

NOTES

is known as Registered Debentures and is transferable by Transfer Deed. When debentures are issued on an option to convert them into shares, they are called as convertible debentures. Where there is no such option they are called as Non-veritable debentures.

Irredeemable Debentures are those for which no date is fixed for re-payment. Of course they are repayable at a time of liquidator of the company or when the company makes a default is paying interest. Redeemable Debentures are to be paid of by the company on or after a certain date.

Redemption means re-payment. There are no legal restrictions on repayment of debentures. However, the terms as announced in the prospects at the time of the issue of debentures must be adhered to. Debentures can be redeemed in one of the following ways.

1. By a single payment at the end of the state period
2. By paying a certain sum every year i.e annual drawings method
3. By purchases in the open market
4. By conversion
5. By sinking fund *

NOTES

1. Redemption by a Single payment

When debentures are issued. Bank A/c is debited and Debentures A/c is credited. When the debentures are re-paid in one, lump sum the following entries will be made

---

Debentures A/c Dr

To Debentures holders A/c

(Being the transfer of debentures of debentures holders a/c)

Debentures holders A/c Dr.

To Bank A/c

(Being the debenture holders paid off)

---

2. Redemption by Annual Drawings

When redemption of debentures are made by annual installment the entry is not different from has been given above (i) Here, the debenture to redeemed are decided by drawing lots.

NOTES

3. Redemption by purchases in the open Market

Another method of redemption of debentures is to buy them in the open market. Law prohibits a company from buying its own shares as it amounts to unauthorized reduction of capital. But the law does not prohibit a company from purchasing its won debentures. For example, 10 debentures of Rs.100 each are purchases in the open market at Rs.95. This represents a profit of Rs.5 per debenture because by paying Rs.95 the liability of Rs.100 will be cancelled. The entry will be

		Rs.	Rs.
Debentures A/c	Dr.	1000	
To Bank A/c			950
To Profit on Redemption of Debentures A/c			50

(Being the redemption of debentures by purchases in the open market)

N.B: The profit on Redemption of Debentures is a capital profit - which may be transferred to Capital Reserve A/c or utilized for writing off any balance in the Discount on issue of Debentures A/c. There is however, no legal objection for distributing the same a dividend. Suppose, in the above case 10 debentures are purchases in the market for Rs.103. There is loss of Rs.3 per debentures. The entry is

		Rs.	Rs
Debentures A/c	Dr.	1000	
Loss on Redemption of Debentures A/c	Dr.	30	
To Bank A/c			1030

(Being the redemption of debentures by purchases in the open market)

N.B: The loss will be written off in the profit and loss A/c

A company may put its own debentures and keep alive (i.e not canceling them) and later sell them again in the market. Then, they should be treated like an investment and an account Own debentures A/c is debited like the cost and Bank a/c is credited. If later these debentures are cancelled, the question of profit or loss arises. Such profit or loss is passed through profit on Redemption of Debentures A/c and loss on Redemption of Debentures A/c respectively. Until the debentures are cancelled, the company will not pay interest on its own debentures. After cancellation the question does not arise. Such a saving of interest is brought into books by debiting debentures A/c and crediting profit and loss A/c

NOTES

What is sinking fund?

A fund accumulated regularly in a separate account and used to redeem debt securities

4. Redemption by conversion

Sometimes, a company instead of redeeming its debentures in cash, may offer the debentures. The following journal entry is necessary to record the conversion.

6% Debentures A/c Dr.
To 9% Debentures A/c
(being the conversion of .... 6% debentures of
Rs ...... each into 9% Debentures of Rs. each)

5. Redemption by Sinking fund

If debentures are to be paid off in a lump sum on a certain date, the company may find a difficult. Therefore, it is advisable to set aside a certain sum of money annually out of the profits and invest the same outside the business, in marketable securities. So, that by the time the debentures nature the company may have sufficient accumulated fund to pay off the debenture holders. Interest received may also be invested. This method of collecting funds is known as

Sinking Fund Method

Annual appropriation required is ascertained by referring to Sinking Fund Tables. The accounting entries for this.

(A) First Year

1. P & L Appropriation A/c Dr. With the amount of the annual
To * Sinking fund A/c installment
(Being the amount appropriated to the
Fund out of profits)

NOTES

2. Sinking Fund Investment A/c Dr. With the amount invested

To bank A/c

(Being the investment the annual investment)

---

* or Debenture Redemption Fund

N.B : Entry (1) represents the intention to make investments

Entry (2) represents the carrying out of the intention to invest

(B) Subscription Years

On Recent of Interest	1.	Bank A/c Dr. To Interest on Sinking Fund Investment A/c (being the interest received on investment)	With the actual interest amount received
On transfer of interest to Sinking Fund A/c	2.	Interest on Sinking Fund Investment A/c Dr To Sinking Fund A/c (being the transfer of the interest to Sinking Fund A/c)	

NOTES

Annual Appropriation	3.	P & L Appropriation A/c Dt. To Sinking Fund A/c (being the amount appropriation to the sinking fund out of profit)	With the amount of annual installment
Investment Made	4.	Sinking Fund Investment A/c Dr. To Bank A/c (being the investment of the annual installment and the interest received)	With the annual installment plus the interest received

(c) Last Year

The above mentioned entries (B) are made very year. The 1st entry (4) will not be passed in the last year because to investment will be made. This is so because, in the last year, all investment will have to be sold in order to pay off the debentures holders. The entries in the last year are in addition to those for.

(B) 1, 2 & 3 given above

On Sale of Investment	Bank A/c Dr. To Sinking Fund Investment A/c (being the sale of investment)	With the actual realized

NOTES

Profit on sale	Sinking Fund Investment A/c Dr. To Sinking Fund A/c (being the profit on sale of investment) OR
Loss on sale	Sinking Fund A/c Dr To Sinking fund investment A/c (being the loss on sale of investment)
Repayment of debentures	Debentures A/c Dr To Debentures holder A/c (being the redemption of debentures)

Debentures holders A/c Dr.

To Bank A/c

(Being the Debentures holders paid off)

NOTES

Illustration: 2

A company issued 5,000 Debentures of Rs.100 each at par on 1st January 2006 redeemable at part on 31st December 2010. A Sinking Fund was established for the purpose. It was expected that investments would earn 5 per cent net. Sinking fund Tables show that Rs.0.180975 amounts to Rs.1 at the end of 5 year @ 5%. On 31st December 2010 the investment realized Rs.3,90,000. On that date the company's bank balance stood at Rs.1,46,600 the Debentures were duly redeemed. Give the necessary ledger accounts along with journal entries. Assume investment were made to the nearest Rs.10

Solution:

To calculate the annual installment to be set aside out of profits, one has to multiply 0.180975 by Rs.5, 00,000. It comes to Rs.90487.50

Journal Entries

Date	Particular	LF	Dr		Cr	
			Rs	Ps	Rs	Ps
2006 Jan 1	Bank A/c Dr To Debentures A/c (being the issue of debentures at part redeemable at par)		5,00,000	00	5,00,000	00
Dec 31	Profit and Loss Appropriation A/c Dr To Sinking Fund A/c (being the amount appropriated to the found out of profits)		90,487	50	90,487	50

NOTES

N.B: Since the first installment in invested at the end of the first year (31-12-06), no interest in respect thereof will be received in the first year.

The student is directed to watch the preparation of Ledger Accounts while making Journal Entries.

	Sinking fund A/c Dr To Bank A/c (being the investment of the annual installment to the nearest *the ten rupee)*		90,490	00	90,490	00
2007 Dec 31	Bank A/c Dr To Investment on Sinking fund investment A/c (being the interest received on investment at 5% on Rs.90,490)		4,524	50	4,524	50
	Interest on Sinking Fund Investment A/c Dr To Sinking Fund A/c (being the transfer of the interest to Sinking Fund A/c)		4,524	50	4,524	50

NOTES

	Profit and Loss Appropriation A/c Dr To Sinking Fund A/c (being the amount appropriated to the fund out of profits)		90,487	50	90,487	50
	Sinking Fund Investment A/c Dr To Bank A/c (being the investment of the annual instalment and the interest received to the nearest ten rupees)		95,010	00	95,010	00
2008 Dec 31	Bank A/c Dr To Interest on Sinking Fund (being the interest received on investment at 5% on Rs.1,85,500)		9,275	00	9,275	00
	Interest on Sinking Fund Investment A/c Dr To Sinking Fund A/c (being the transfer of interest a/c)		9,275	00	9,275	00

	Profit &Loss Appro A/c Dr		90,487	50		
	To Sinking Fund A/c				90,487	50
	(being the amount appropriated to the fund out of profits)					
	Sinking Fund Investment A/c Dr		99,760	00		
	To Bank A/c				99,760	00
	(being the investment of annual installment and the interest received to the nearest ten rupees)					
2009	Bank A/c Dr		14,263	00		
Dec	To Interest on Sinking A/c				14,263	00
31	(being the interest received on investment at 5% on Rs.2,85,260)					
	Interest on Sinking Fund		14,263	00		
	Investment A/c Dr				14,263	00
	To Sinking Fund A/c					
	(being the transfer of interest a/c)					

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	Profit & Loss Appro A/c Dr To Sinking Fund A/c (being the amount appropriation to the fund out of profits)		90,487	00	90,487	00
	Sinking Fund Investment A/cDr To Bank A/c (being the investment of the annual installment and interest received to the nearest ten rupees)		1,04,750	00	1,04,750	00
2010 Dec 31	Bank A/c Dr To Interest on Sinking Fund Investment A/c (being the interest received 5% on Rs.3,90,010)		19,500	00	19,500	00

NOTES

	Interest on Sinking Fund Investment A/c Dr		19,487	50		
	To Sinking Fund A/c				19,487	50
	(being the transfer of interest to sinking fund A/c)					
	Profit & Loss Appro A/c Dr		90,487	50		
	To Sinking Fund A/c				90,487	50
	(being the amount appropriated to the fund out of profits)					
	Bank A/c Dr		3,90,00	00		
	To Sinking Fund Investment A/c				3,90,00	00
	(being the sale of investment A/c)					
	Sinking Fund A/c Dr		10	00		
	To Sinking Fund Investment A/c				10	00
	(being the loss on sale of investment transferred to sinking fund A/c)					

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	Debentures A/c Dr To Debentures holders A/c (being the debentures A/c Closed and Transferred to sinking fund A/c)		5,00,000	00	 5,00,000	 00
	Debentures holders A/c Dr To Bank A/c (being the debentures holders paid off)		5,00,000	00	 5,00,000	 00
	Sinking Fund A/c Dr To The General Reserve A/c (Transferred to G/R A/c)		4,99,990	50	 4,99,990	 50

Sinking Fund A/c

Dr. Cr.

Date	Particular	Rs.	Ps	Date	Particular	Rs.	Ps
2006 Dec.31	In Balance c/d	90,847	50	2006 Dec 31	By P & L Appropriation A/c	90,847	50
		90,847	50			90,847	50
2007 Dec.31	To Balance c/d	1,85,499	50	2007 Jan 1	By Balance b/d	90,487	50
				Dec.31	By Interest on Sinking Fund Investment A/c Installment 5% on Rs. 90,490	4,524	50
					By P & L Appropriation A/c	80,487	50
		1,85,499	50			1,85,499	50
2008 Dec.31	To Balance c/d	2,85,262	00	2008 Jan.1	By Balance b/d	1,85,499	50
				Dec.31	By Interest on Sinking Fund Investment A/c Installment 5% on Rs. 1,85,500	9,275	00
					By P & L Appropriation A/c	90,487	50
		2,85,262	00			2,85,262	00
2009 Dec.31	To Balance c/d	3,90,012	50	2009 Jan.1	By Balance A/c	2,85,262	00
				Dec.31	By Interest on Sinking Fund Investment A/c Installment 5% on Rs. 2,85,260	14,263	00
					By P & L Appropriation A/c	90,487	50
		3,90,012	50			3,90,012	50
2010 Dec.31	To Sinking& Fund Investment A/c	10	00	2010 Jan.1	By Balance c/d	3,90,012	50
	To General Reserve A/c Transfer	4,99,990	50	Dec.31	By Interest on Sinking Fund Investment A/c Installment 5% on Rs. 3,90,100	19,500	50
					By P & L Appropriation A/c	90,487	50
		5,00,000	00			5,00,000	00

NOTES

NOTES

Sinking Fund Investment A/c

Dr. Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
2006 Dec.31	To Bank A/c	90,490	2006 Dec 31	By Balance c/d	90,490
		90,490			90,490
2007 Jan.1	To Balance c/d	90,490	2007 Dec.31	By Balance c/d	1,85,500
Dec.31	To Bank A/c	95,010			
		1,85,500			1,85,500
2008 Jan.1	To balance b/d	1,85,000	2008 Dec.31	By Balance c/d	2,85,260
Dec.31	To Bank A/c	99,760			
		2,85,260			2,85,260
2009 Jan.1	To Balance b/d	2,85,260	2009 Dec.31	By Balance c/d	3,90,010
Dec.31	To Bank A/c	1,04.750			
		3,90,010			3,90,010
2010 Jan.1	To Balance b/d	3,90,010	2010 Dec.31	By Bank A/c	3,90,000
				By Sinking Fund Investment A/c Loss Transferred	10
		3,90,010			3,90,010

Interest on Sinking Fund Investment

Dr. Cr.

		Rs.	Ps			Rs.	Ps
2006 Dec.31	To Sinking Fund A/c Transfer	4,524	50	2007 Dec 31	By Bank A/c	14,236	50
2008 Dec.31	To Sinking Fund A/c Transfer	9,275	00	2008 Dec 31	By Bank A/c	9,275	00
2009 Dec.31	To Sinking Fund A/c Transfer	14,263	00	2009 Dec 31	By Bank A/c	26,314	00
2010 Dec.31	To Sinking Fund A/c Transfer	19,500	00	2010 Dec 31	By Bank A/c	10,500	00

NOTES

Debentures A/c

Dr. Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
2006 Dec.31	To Balance c/d	5,00,000	2006 Jan.1	By Bank A/c	5,00,000
		5,00,000			5,00,000
2007 Dec.31	To Balance c/d	5,00,000	2007 Jan.1	By Balance b/d	5,00,000
		5,00,000			5,00,000
2008 Dec.31	To balance b/d	5,00,000	2008 Jan.1	By Balance b/d	5,00,000
		5,00,000			5,00,000
2009 Dec.31	To Balance b/d	5,00,000	2009 Jan.1	By Balance b/d	5,00,000
		5,00,000			5,00,000
2010 Dec.31	To Debenture Holder A/c Transfer	5,00,000	2010 Jan.1	By Balance b/d	5,00,000
		5,00,000			5,00,000

Bank A/c

Dr. Cr.

		Rs.			Rs.
Dec. 31	To balance b/d	1,45,600.00	Dec. 31	By Debenture holder A/c	5,00,000.00
	To Sinking Fund A/c (Int)	19,500.50		By Balance c/d	55,100.50
	To Sinking Fund Investment A/c	3,90,000.00			
		5,55,100.50			5,55,100.50
	To balance b/d	55,100.50			

NOTES

Debentures Holders A/c

Dr. Cr.

		Rs.			Rs.
2010 Dec.31	To Bank c/d	5,00,000		By Debentures A/c	5,00,000
		5,00,000			5,00,000

Illustration: 3

Cee come Ltd's books show the following balance on 1st January 2010

8% Mortgage Debentures Rs. 5,00,000

Debenture Redemption Fund Rs. 3,80,000

5% Government papers against Debentures

Redemption Fund Rs. 3,79,000 (Face Value)

Bank Balance Rs. 1,30,000

On this date Government papers were sold at Rs.98. The debentures were redeemed Give Ledger Accounts concerned.

NOTES

Solution: Debenture Redemption Fund Investment A/c

Dr. Cr.

		Rs.			Rs.
2010			2010		
Jan.1	To balance b/d (3)	3,79,000	Jan.1	By Bank A/c Sale at 98% of Rs.3,79,000 (2)	3,71,420
				By Sinking Fund A/c Loss Transferred (3)	7,580
		3,79,000			3,79,000

8% Mortgage Debenture A/c

Dr. Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
~~2010~~			~~2010~~		
Jan.1	To Debentures holders A/c (2)	5,00,000	Jan.1	By Balance b/d	5,00,000
		5,00,000			5,00,000

NOTES

Debenture Redemption Fund A/c

Dr. Cr.

		Rs.			Rs.
2010			2010		
Jan.1	To Debentures Redemption		Jan. 4	By Balance b/d	(1)
	Fund Investment A/c Loss	7,580			
	To General Reserve A/c	3,72,420			
		3,80,000			3,80,000

Debenture Holders A/c

Dr. Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
2010	To Bank A/c (1)		2010	By 8% Mortgage	
		5,00,000		Debentures A/c (1)	5,00,000
		5,00,000			5,00,000

Bank A/c

Dr. Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
2010			2010		
Jan.1	To balance b/d (1)	3,79,000	Jan.1	By Debenture holders A/c (3)	5,00,000
	To Debentures Redemption Fund Investment A/c	3,71,420		By Balance c/d (4)	1,420
		5,01,420			5,01,420
	To Balance b/d (5)	1,420			

Purchase of Debentures before the specified date of payment of Interest

Debenture interest is generally paid either annually (i.e on 31st December every year) or half year on specified dates (i.e 30th June and 31st December every year). If the debentures are purchases exactly on these dates, it will not give rise to any problem. But if the debentures are purchased before the specified date if interest payment the company has to pay interest for the expired period on that date of purchase. The price paid itself may include interest upto the date purchases. In such a case the price paid is known as Cum Interest. Price, on the other hand if interest for

NOTES

the expired period is to be paid over and above agreed price, the price and is termed "ex-interest" price, whether the price paid is ex-interest, or cum-interest the interest for the expired period should treated separately from the price actually paid for the debentures. Suppose company has issued 105 Debentures of Rs.100 each and interest is payable on 30th June and 31st Dec every year. On 31st March the company purchases. 1,000 of it won debentures at Rs.96 each for immediate cancellation.

(a) If the price paid is cum interest

If the price paid is cum interest Rs.96 includes interest for 3 @ 10% p.a. Which amounts to?

$$100 \times \frac{10}{100} \times \frac{3}{12} = \text{Rs. } 2.50$$

Therefore the price actually paid for the debenture should be taken at (Rs.96-2.50) = Rs.93.50 per debenture.

The accounting entry should be as follows.

		Rs.	Rs.
10% Debentures A/c	Dr.	1, 00,000	
Debenture Interest A/c	Dr.	2,500	
To Bank A/c			96,000
To profit on Redemption of debenture A/c			6,500

b) If the price is ex-interest

To the price paid is ex-interest, Rs.96 does not include interest for the period from 1st Jan. March. Over and above Rs.96 the company should pay Rs.2.50 towards interest for the expired period. The accounting entry should be as follows.

		Rs.	Rs.
10% Debentures A/c	Dr.	1,00,000	
Debenture Interest A/c	Dr.	2,500	
To Bank A/c			98,500
To profit on Redemption of debenture A/c			4,000

Illustration: 4

On 1st July 2008 a company issued 1000, 12% Debentures of Rs.100 each (interest payable on 30th June and 31st December). The company is allowed to purchase own debentures which may be called or kept reissued at the option of the company. The company made the following purchases in the open market.

On 31st May 2009, 005 Debentures @ Rs.98 ex-interest on 30th September 2009 Debentures @ Rs.97 cum interest. The debentures purchased on 31st May 2009 were cancelled on 31st December 2009. Give entries to record the transaction and show the Balance Sheet on 31st Dec. 2009.

NOTES

Solution:

Date	Particular	Dr.	Cr
2008 July 31	Bank A/c Dr To 12% Debenture A/c (Issue of 1000 Debentures of Rs.100 each at par)	1,00,000	 1,00,000
Dec. 31	Debenture Interest A/c Dr To Bank A/c (Interest on Debentures for 6 months paid)	6,000	 6,000
2009 May 31	Own Debentures A/c Dr Debentures Interest A/c Dr To Bank A/c (Purchase of Debentures @ Rs.98 ex-interest)	9,800 500	 10,300
June 30	Debentures Interest A/c Dr To Bank A/c To Interest on own Debentures A/c (Interest for six months on 900 Debentures and for six months on own debentures)	5,500	 5,400 100
Sep. 30	Own Debentures A/c Dr Debentures Interest A/c Dr To Bank A/c (Purchase of 50 Debentures @ Rs.97 cum-interest)	4,700 500	 4,850
	Debentures Interest A/c Dr To Bank A/c To Interest on own Debentures A/c (Payment of interest and interest on own debenture)	5,850	 5,100 750
	12% Debentures A/c Dr To Own Debenture A/c To Profit on Redemption of Debentures (Cancellation of 100 own debentures)	10,000	 9,800 200

NOTES

LESSON-7

COMPANY FINAL ACCOUNTS

7.1 INTRODUCTION

We will discuss the preparation of final Accounts of Joint Stock Companies (i.e. the Profit & Loss Accounts and the Balance Sheet) It may be mentioned that the Profit and Loss Account of a company is prepared generally, on the same basis as in case of the sole trader or partnership firm. However, the Indian Companies Act makes some special provisions in this respect. The act requires that at every annual general meeting, directors shall present a balance sheet along with a profit and loss account. According to the Act 'every profit or loss of account of a company shall give true and fat view of the profit or loss of the company for the financial year. Similarly every balance sheet shall give a true and fair view of the state of the affairs of the company' as at the end of the financial year. The profit and loss account must comply with the requirements of part ii of schedule VI of the act as far as they are applicable. The balance sheet shall be in the form set out in Part I of Schedule VI of the Act or near there to as circumstances admit. The provisions of which separate forms have been prescribed under the respective Act.

NOTES

A copy of the Profit & Loss Account together with Balance Sheet with the auditor's thereon must be sent by the company at least 21 days before the date of the annual general meeting to every member debentures holder and the auditor of the company.

What is profit and Loss account?

An account compiled at the end of an accounting period to show gross and net profit or loss

7.2 PROFIT AND LOSS ACCOUNT

The law does not mention anything about dividing profit and loss account into trading account, profit and loss account and profit and loss appropriation A/c. In practice it is prepared in three sections. Such Accounts is called.

Profit and loss account

Financial year, here means the period in respect of which the accounts are made up # it means that

(a) the assets and liabilities are correctly described

(b) The stock is valued on consistent basis

It means balance sheet and profit and loss account.

A Company must hold its , 1st annual General Meeting within 18 months of its incorporation and must hold subsequently and annual General meeting in each year at an interval of not more than 15 months from the preceding Annual General Meeting must be hold within 6 months, after the close of the financial year of the company.

PROFIT AND LOSS ACCOUNT

Opening stock of good produced or	Total sales or gross income derived
purchased	from services rendered
Purchase or Raw materials for goods	closing stock of goods produced or
Work in progress at the beginning	purchased
consumption of stores and spare parts	Work in progress at the end
Power and Fuel	
Wages, bonus etc.	
Contribution to worker's provident	
fund etc.	d. income from investment
Workmen's Welfare expenses	e. Profits or loss on investment or in
Rent, Rates and taxed	respect of transactions of a kind not
Insurance	usually under taken.
Repairs	f. Miscellaneous income
Miscellaneous Expenses	g. Dividends form subsidy companies
Commission, brokerage and discount	
on sales to selling ages	h. balance from previous period
Depreciation	i. Net profit for the current year
Interest on debenture	
Amount set aside for meeting special	
liabilities contingencies or	
commitments.	
Income tax relating to current year	
Income tax relating to previous year	
Amount provided for Redemption of	
debentures	
Amount set aside for reserve or fund	
Dividend paid or proposed	
Balance Transferred to balance sheet	

NOTES

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PROFIT AND LOSS APPROPRIATION ACCOUNT

The profit and loss appropriation account is a part of the profit and loss account. The idea is to show the amount of dividable profits and how the same have been appropriated.

Note items numbered...............

1 to 8 and A to C are generally entered in the Trading account

9 to 17 and D to G are entered in the usual profit and loss account and

18 to 22 and H and I are entered in the profit and loss appropriation a/c

Of course, there is no need to split the profit and loss account to 3 sections. It is recommended because, the gross profit and divisible profit that can be readily known. Figure relating to the previous year should be given in the profit and loss account. The following vertical form also may be adopted.

profit and loss account for the year ended ....

	Schedule	Current year	Previous year
Income		xxxx	xxxx
Sales		xxxx	xxxx
Other Income		xxxx	xxxx
Increase / Decrease in Work-in-progress finished stocks		xxxx	xxxx
Total		xxxx	xxxx
Expenditure		xxxx	xxxx
Cost of Raw materials and spares		xxxx	xxxx
Excise Duty		xxxx	xxxx
Employees ' Remuneration & Benefits		xxxx	xxxx
Other expenses		xxxx	xxxx
interest		xxxx	xxxx
Depreciation			
Total		xxxx	xxxx
Profit before taxation & extraordinary items		xxxx	xxxx
Extraordinary item		xxxx	xxxx
Profit for the current year		xxxx	xxxx
Prior for the current year		xxxx	xxxx
prior period adjustments		xxxx	xxxx
profit before taxation		xxxx	xxxx
provision for taxation		xxxx	xxxx
profit after tax		xxxx	xxxx
Balance B/F form the previous year			
Total available for appropriations		xxxx	xxxx
Appropriations		xxxx	xxxx
Proposed dividend		xxxx	xxxx
Corporate dividend on Taxes (CDT)		xxxx	xxxx
Debenture redemption reserve		xxxx	xxxx
General Reserve		xxxx	xxxx
Any other statutory reserves		xxxx	xxxx
balance c/f to next year			
Total of appropriations &balance d/f			

NOTES

Notes to the format:

1. Profit and loss account schedules are numbered after the schedules of balance sheet, and therefore start with higher numbers.
2. In some annual reports adjustments relating to work –in-progress and finished stocks and carried to materials consumed
3. Under other expenses there can be more classifications such as manufacturing expenses, administration expenses, selling, and distribution expenses etc.,
4. Each schedule gives more details as the income statement avoids showing such details. For example sales may give details of sales by product and / or territory.
5. The schedule of other income will show items as profit on sale of fixed assets or investments and such other items.
6. It may be noted that both extraordinary items and prior period items form part of current profits but they are shown separately so that the users can understand the impact of such items on current profit.
7. In the preparation of profit and loss account each enterprise has a choice in accounting policies with respect to revenue recognition, inventory valuation, depreciation, foreign currency translation, valuation of investments etc. As per AS-1 every enterprise has to disclose significant accounting policies, as part of Annual Accounts. Generally a schedule to the accounts discloses the selected accounting policies.

NOTES

8. The change in any accounting policy and its impact on current profit will be mentioned only in the notes to accounts and will not be shown in the income statement.

9. The change in any accounting policy and its impact on current profit will be mentioned only in the notes to accounts and will not be shown in the income statement.

7.3 BALANCE SHEET

Balance sheet must be prepared in the prescribed form as set out I Part I schedule VI of the companies Act. The Central Government may permit other forms either generally or in particular case. Under Schedule VI. Both the forms have a column indicating the figures of the immediately preceding financial year in respect of eacn of the items shown in the balance sheet.

This form does not apply to banking, insurance, and electricity companies which are governed by special statues and the formats for financial statements are prescribed therein.

Companies while preparing the balance sheet must not only conform to the format but must also adhere to notes and general instructions given in eh schedule. For instance the Department of Company Affairs (DCA) has stated that it would not be desirable to use the general reserve for the purpose of redeeming the preference shares as long as there is a debit balance in the profit and loss account. Vertical balance sheet which is very simple is supported by a number of schedules which give

NOTES

details under each of the items. The schedules giving such details , significant accounting policies and explanatory notes form an integral part of the balance sheet.

A foot note is added to the balance sheet, companies are also required to give balance sheet abstract and company's general business profile in the prescribed format. A Skeleton summary of the horizontal balance sheet is given below. After that, the two types of balance sheets, as prescribed in Part I of Schedule VI, are reproduced.

Horizontal balance sheet (in skeleton form)

Liabilities	Rs.	Assets	Rs.
Share Capital		i. Fixed assets	
Reserves and surplus		ii. investments	
Secured loans		iii. current assets and loans and advances	
Unsecured loans			
Current liabilities and provisions		Current Assets	
current liabilities		Loans and Advances	
provisions		iv.Miscellaneous Expenditure	
		v. Profit and Loss account (debit balance)	

Illustration: 1 Meena Co., Ltd has the following Trial balances as on 30th June 2009.

Stock (30th June 2008)	150000	
Sales		700000
Purchases	490000	
Productive Wages	100000	
Discount	14000	10000
Salaries	15000	
Rent	9900	
General Expenses and Insurance	34100	
profit and loss account (30.06.08)		30060
Dividend paid, August 2008	10000	
Interim dividend paid February 2009 capital	8000	
(Authorized issued and subscribed)		
5000 Equity shares of Rs. Full paid '		100000
5000 6% preference shares of Rs.20 Fully paid		100000
Fully paid		35000
Debtors & Creditors	75000	
Debtors & Creditors	58000	
Plant & Machinery	32400	
Reserve		31000
Loan to Managing Director	6500	
Bad Debts	3160	
	1006060	1006060

Stock 30th June 2009 Rs. 164000. You are required to make out the profit and loss account for the year ended 30th June 1994 and the balance sheet as on the date.

You are also to make provision on respect of the following.

Depreciate plant & Machinery 10% p.a.
Reserve 5% Discount on Debtors
Allow 2 ½ discount on Creditors
Provide managing Director's Commission at 5% profit before sharing his commission
One month's rent (Rs.99) per month was due on 30th June 2009
Six month's insurance unexpired at Rs. 1500 per annum

NOTES

Solution:

Meena Co.Ltd.,

Trading and profit and loss account for the year ending 30th June 2009

Figures for the previous year			Figures for the previous year			
	To Opening stock	150000		By Sales		700000
	To purchase	490000		By closing stock		164000
	To Productive wages	100000				
		124000				
	To Gross profit A/c	864000				864000

Meena Co. Ltd.,

Trading and Profit and Loss account for the year ending 30th June 2009

Figures for the previous year	Particulars	Rs.	Figures for the previous year	Particulars	Rs.	Rs.
	To Discount		14000			
	To Salaries		15000			
	To Rent	9900				
	To add outstanding	900	10800	By Gross profit		124000
	To General Exp. &	34100		B/d		
	Insurance	750	33350	By Discount		10000
	To Less Prepaid		3160			
	To Bad Debts		3750	By Reserve for		875
	To Reserve for		5800	discount on		
	Discount on Drs.		2334	Crs.		
	To Depreciation on					
	plant at 10%		46681			
	To managing					
	director's					
	Commission					
	To Net profit A/c					

Balance sheet on Meena Co. ltd., as at 30th June 2009

Figures for the previous year	Particulars	Rs.	Figures for the previous year	Particulars	Rs	Rs.
	Share Capital					
	authorized 5000	10000		Fixed Assets		
	Equity shares of	0		Plant &	58000	
	Rs.20 each 5000		200000	Machinery		
	preference shares	10000				52200
	of Rs.20 each	0		Less :	5800	
	issued Capital		200000	Depreciation at		
	5000 equity	10000		10%		
	shares of Rs. 20	0	89741	II investment		
	each	10000	Nil	II Current		
	5000 6%	0		Assets Loans		
	preference shares	31000		and advances	16400	
	of Rs. 20 each	58741	Nil	Current Assets	0	
	I. Reserve &			:		
	surplus					235250
	profit & Loss A.c			Stock	71250	32400
	III Secured loan			Debtors		
		35000	35025	75000		
	IV Unsecured			Less: Reserve		
	Loan	875		for Discount at		
	V Current			5% 3750	6500	
	Liabilities &	34125	2334	Cash in hand &		
	Provisions			at Bank Loans		
	(a) Current	900		and Advances	750	7250
	Liabilities					Nil
	Creditors for			Loan to		
	goods			Managing		
	Less : Reserve at			Director		
	2 ½ creditors for			Unexpired		327100
	rent		327100	insurance		
	(B) Provisions			IV		
	For managing			miscellaneous		
	Director's			expenditure		
	Commission			V Profit and		
				Loss account		

NOTES

Illustration: 2

The following is a list of balance extracted from the books of the Dry cell Manufacturing Company Ltd as at 31st March 2009.

Authorized capital		Rs.
1,00,0000 Equity shares of Rs.2 each of which		50,000
Equity shares issued and fully paid up		1,00,000
Reserve Fund		20,000
Good will		20,000
8% Debentures 1-4-2008		30,000
Freehold Land and Buildings		47,000
Machinery and Plant 1-4-2008 Stock		20,000
	Rs.	
Raw material	30,000	
Manufactured Goods	16,000	46,000

NOTES

Debtors	45,000
Creditors	16,000
Bills receivable	8,000
Bills payable	5,490
Punjab National Bank	6,000
Sales	1,83,700
Purchases Returns of Raw Materials	1,000
Discount allowed	2,000
Transfer received	1,240
Manufacturing wages	32,000
Freighted on Raw Materials	1,000
Factory Expenses	9,000
Factory Salaries	5,000
Office salaries	3,000
Royalties on process	2,500
Bad Debts	1,500
General Office Expenses	1,500

NOTES

Director's fee	1,200
Interest on Debentures	1,200
Interim Divined paid	5,000
Profit & Loss A/c (Cr) Balance	7,630
3% Government bonds	8,000
Sales returns	2,400
Purchase of Raw Materials	88,000
Interest of Govt. Bonds received	240

The closing Stock was valued on 31st March 2009 as follows

Materials	Rs. 24,000
Manufacturing goods	Rs. 14,380

The following provocation has to be made:

(a) Interest on debentures

(b) Depreciation on Plant & Machinery of 10%

(c) Reserve for Doubtful Debts at 3% on Debtors

Draw the Manufacturing and Profit and Loss Account for the year ended 31.03.2009 and Balance Sheet as at 31st March 2009.

NOTES

Solution

The Dry Cell Manufacturing Co Ltd

Manufacturing Account For the year ending 31st December 2009

Particulars	Rs.	Rs.	Particulars	Rs.	Rs.
To Raw Materials Consume			By Cost of		
Opening Stock	30,000		Production transferred to Trading A/c		1,45,500
Purchase Rs. 88,000					
Less Returns 1,000	87,000				
	1,17,000				
Less Closing Stock	24,000	93,000			
To Manufacturing Wages		32,000			
To Freight etc		1,000			
To Factory Expenses		9,000			
To Factory Salaries		5,000			
To Royalties on process		2,500			
To Depreciation on Plant & Machinery at 10%		3,000			
		1,45,500			1,45,500

NOTES

	Liabilities	Rs	Rs	Assets	Rs	Rs
	To opening stock		16,000	By Sales	1,83,700	
	of Manufactured					
	Goods					
	To cost of goods		1,45,000	Less Returns	2,400	1,81,300
	transferred			By closing stock of		
	To Manufactured A/c		34,180	Manufacturing		
				goods		
			1,95,680			1,95,680
	To Office salaries		3,000	By Gross profit b/d		34,180
	To Bad Debts		1,500	By interest on		
	To General Office Exp.		1,500	Govt Bonds		240
	To Int. on Debentures		1,200			
	To Director's Fee	1,200		By Transfer Fee		1,240
	Add : Outstanding	1,200	2,400			
	To Discount		2,000			
	To Reserve for Doubtful Debts		1,350			
	To Net Profit		22,710			
			35,660			35,660

Balance Sheet the Dry Cell Manufacturing Co Ltd As at 31st December 2009

Liabilities	Rs	Rs	Assets	Rs	Rs
1.Share Capital Authorized 1,00,000 Equity shares of Rs. 2/- each		2,00,000	I. Fixed Assets Goodwill	20,000	
Issued & Subscribed 50,000 Equity shares of Rs.2/- each		1,00,000	Freehold Land & Building	47,000	
			Plant & Machinery 30,000		
II.Reserve&Surplus Reserve Fund	20,340		Less : Depreciation at 10%		
Profit & Loss A/c	25,000	45,340	3,000	27,000	
III.Secured&Loans			II. Investment		94,000
8% Debentures	30,000		3% Government Bonds		8,000
Interest accrued	1,200	31,200			
IV.Unsecured loans		Nil	III. Current Assets Loans & Advances		
V.Current Liabilities and Provision			(A) Current Assets		
			Stock Raw Materials	24,000	
Sundry Creditors For Goods	16,000		Manufactured goods	14,380	38,380
For Acceptance	5,490	21,490	Bills Receivable		
			Sundry Debtors 45,000 Less Reserve for Bad Debts at 3% 1,350	43,650	51,650
			Cash at Punjab National Bank		6,000
			(b) Loans and Advances		
			IV. Miscellaneous Expenditure		Nil
			V. Profit and Loss A/c		Nil
		198030			198030

NOTES

7.4 DIVIDEND

What is Dividend?

That part of the earnings of a corporation that is distributed to its shareholders

A dividend is a share profit of a company. The term dividend is applied to total sum dividend and also to the portion received by each individual shareholders. When the payment of dividend has been recommended by the Directors and approved by the shareholders in general body meeting. It is said to have been declared by the company when declare, the dividend becomes a debt on the company (but does not bear interest) and its payment can be enforced by the shareholders. If is usually paid as percentage on either the paid up share capital or the nominal value of shares as laid down in the Articles of Association, Generally dividend to be paid by a company is calculated on the amount of paid up share capital minus calls in Arrear. Dividend can also be paid at the rate of so many rupees per share. Orders for payments called dividend warrant to each shareholder who can encash it either at the company's office or at the bank mentioned thereon. In addition to whatever tax the company pauses on its profits it has to deduct income tax at prescribed rates and to deposit the same with the Central Government. A share holder can get proper refunds from the income tax authorities after producing the certificate issued by the company in this regard.

The company is general meeting may declare dividends, but no dividend shall exceed the amount recommended by the Board of Directors.

NOTES

Note:

All dividends must be paid in cash, but his does not prohibit the issue of Bonus Shares it certainly prohibits the companies from the practice of the distribution of Strip dividend i.e. the dividend in the form shares of others companies which may have been held by it investment. If the dividend warrant has not been posted within 42 days from the date of declaration the officers of the company are punishable.

1. Dividend

Suppose a company has issued 10,000 Equity share of Rs.100/- each on which Rs.80/- per share has been paid up 10% dividend I declared. The amount of dividend payable is.

$$\text{Rs. } 8,00,000 \times \frac{10}{100} = \text{Rs. } 80,000$$

(Note: The Company can declare a dividend on the full nominal value of the share, even it the paid up mount is less, in that case, the above dividend will come to Rs.10, 000. However calls in advance cannot be treated as part of paid up capital for declaring dividend)

NOTES

Illustration: 3

The accounts of a Joint Stock company disclose a net profit of Rs.1,50,000 for the ended 31st December 2005. The balance of profit brought forward from 2004 was Rs.30,000. The Board of Directors recommended that:

a) A dividend of 8% no 10,000 preference shares of Rs.10 each be paid

b) A dividend of Rs.12 per share on 5,000 Equity shares and

c) Rs. 32,000 be paid to the employee as bound

d) Transfer Rs.50, 000 to Reserve Fund. Make Journal Entries and show Profit & Loss Appropriation A/c

Solution

Date	Particular	L.F	Dr.	Cr
2005	Profit & Loss Appropriation A/c Dr To Preference Share Dividend A/c To Equity Share Dividend A/c To Bonus to Employee A/c To Reserve Fund (being the payment of Dividend Bonus etc as per Resolution dt.)		1,50,000	 8,000 60,000 32,000 50,000
	Preference Share Dividend A/c Dr Equity Share Dividend A/c Dr Bonus to Employees A/c Dr. To Bank A/c (being the payment of Dividend and bonus)		8,000 60,000 32,000	 1,00,000

NOTES

Profit & Loss Appropriation A/c

Dr. Cr.

Particulars	Rs.	Particulars	Rs.
To Pref Dividend at 8% on Rs.1,00,000	8,000	By balance b/d	30,000
To Equity Dividend at Rs.12 per share on 5,000 shares	60,000	By Profit for the year	1,50,000
To Bonus to Employees	32,000		
To Reserve Fund	50,000		
To Balance c/d	30,000		
	1,80,000		1,80,000
		By Balance c/d	30,000

Interim Dividend

An interim dividend is a dividend paid before the close of the company's accounting period, either out of profits are accruing, or out profits brought from a previous period. if is said to be a final dividend when a dividend is declared out of the profits as shown by the tinal accounts prepared by the company.

Dividend cannot be paid out of capital

It has already been pointed out that dividends can be paid out of profits. If a company declares and pays a dividend in the absence of profits, the directors will to make good the into the company form their own pockets.

Dividends can be paid out of Capital Profits

We have learned that dividends cannot be declared except out of profit. That is dividends can be shared out of revenue profits. Dividends can be declared out of the following 'Capital Profits. Profit on sale of Fixed Assets, Profit on Acquisition of a business and Premium on Issue of Debentures, Premium of Redemption of Debentures.

Dividend Profits

The expression "Dividend Profits" means all profits can be legally distributed to the shareholders of company in the form of 'Dividend'. Now, the legal decision of the English Courts relating to divisible profits is not applicable to India. Companies Act 1956 has clarified the law governing divisible profits. According of Section 205 (1) a dividend can be declared or paid for any financial year only out of fits. The expression profits will include revenue profits or capital profits or past in distributed profits. In law four board principles govern the payment of dividends by a company.

NOTES

1. The interest of outside creditors must be protected.

2. The shareholder's capital must not been used to pay dividend.

3. There must be bonafide profit from which to pay dividend.

4. Dividends are payable according to the Articles of Association or in their absence according to given in table A of Schedule I of the Companies Act. The Articles must not be ultravires the provisions of the Companies Act.

Issue of Bonus Share or Capitalization of Reserve

Each company tries to build up a strong General Reserve out of annual profits. When the Reserve has accumulated to an amount in excess of the present of future needs it may be deemed desirable to give benefit of a part of such Reserve to the existing shareholders by way of compensation for the loss of dividends which was suffered in the past. This desire on the part of the Board of Director stakes the form of an issue of bonus shares such issue has to be sanctioned by a General body Meeting of shareholders.

Bonus Share can be issued out of the following:

1. General Reserve

2. Capital Redemption Reserve

3. Capital Reserve and Profits

4. Profit and Loss Appropriation A/c (Credit Balance)

5. Sinking Fund or Debenture Redemption Fund

** 6. Share Premium

NOTES

The issue of such shares and the sources for it has to be disclosed in the Balance Sheet. The following advantages are derived by a company by issuing bonus Shares:

1. The Company which is not in position to pay dividends in cash in spite of availability of adequate profits to avoid adverse effect on the working capital can keep it assets intact while satisfying the shareholders by issuing such shares.
2. It is an easy method for the capitalization of reverse and accumulated profits
3. It portrays a realistic relationship between capital and profits
4. It helps to check the speculative tendencies in the company's shares, since the rate of dividend will reduce normally by issue of such shares.

The shareholders derive the following advantages from such shares:

1. Issue of bonus shares provides a feeling of security in the company as the reserve which were accumulated have now been passed on to them in the form of bonus shares.
2. This reduced the uncertainty regarding the uses to which the company may put its built up reserves from the mind of investors.
3. The value of their shares is stabilized and the curtailment of speculative activities over their holdings tends to appreciate their value in the long run.

NOTES

Illustration: 4 **(Simple)**

Bala Company Ltd. Having a paid up capital of RS.2, 00,000 dividend into 20,00 shares of Rs.10 each, has accumulated a Reserve Fund of RS.60,000. It resolves to capitalize of it by issuing 4,000 bonus shares of Rs.10/- each fully paid at the rate of one bonus share for every five shares held in the company on 31st December 2009. Jouranlise and Exhibit the Balance Sheet.

Solution **Journal of Bala Co. Ltd**

Date	Particular	L.F	Dr.	Cr
2009 Dec.31	Reserve Fund A/c Dr To Bonus to Shareholders A/c (being the amount of bonus payable out of Reserve fund as per Resolution dated)		40,000	40,000
	Bonus to Shareholders A/c Dr To Share Capital A/c (being the allotment of 4,000 bonus shares of Rs.10 each as per Resolution dated)		40,000	40,000

NOTES

Bala Co Ltd

Balance Sheet as at 31st December 2009

Liabilities	Rs.	Assets	Rs
Share Capital			
Authorised :			
…. shares of Rs. Each		Sundry Assets	2,60,000
Issued Subscripted & Paid up :			
24,000 shares of Rs.10 each	2,40,000		
of the above 4,000 shares			
were issued as Bonus Shares			
on 31.12.2009 out or			
Reserve fund Rs.40,000)			
Reserve Fund	20,000		
	2,60,000		2,60,000

NOTES

Illustration: 5 **(Fully Paid and Proportionate Basis)**

A company with a subscribed capital of 10,000 shares of Rs.10 each had called up Rs.8 per share. The directors recommend the following with a view to capitalizing the reserve.

(a) The existing shares are made fully paid without the share holders having to pay anything.

(b) Each shareholder to be given proportionate to his holdings bonus shares of Rs.10 for the remaining amount the shares to be valued at Rs.15 per shares. Give Journal Entries and show in what proportion bonus shares will be distributed among the shareholders assuming that the company has Rs.50, 000 in the Reserve fund.

Solution:

Journal

Date	Particular	L.F	Dr. Rs.	Cr Rs.
	Reserve Fund A/c Dr To Bonus to Shareholders A/c (being the bonus of payable out of Reserve as per Resolution dated)		50,000	50,000
	Share Final Call A/c Dr To Share Capital A/c (being the final call money due on 10,000 shares at Rs.2 per share as per Resolution dated)		20,000	20,000
	Bonus to Shareholders A/c Dr To Share Final Call A/c (being the amount applied towards meeting the final call due on 10,000 share at Rs.2 per shares as per Resolution dated)		20,000	20,000
	Share Shareholders A/c Dr To Share Capital A/c To Share Premium A/c (being the allotment of 2,000 bonus share of Rs.10 each Rs.15 per share as per Resolution dated)		30,000	20,000 10,000

Working: Statement Showing the Distribution of Bonus Shares

	Rs.
	50,000
Available Reserve Fund	
Less: Final Call due Rs.2 per share on 10,000 shares to be met	
Out bonus to shareholders	20,000

	30,000
Remaining Reserve Fund	
Less : Total number to bonus share of Rs.10/-	30,000
30,000/15=2,000 shares	---------

As such, shareholders will receive one bonus share for every five shares held

(i.e)	Total Shares	-	Bonus Shares
	10,000	-	2,000
	5	-	1

Rights Issue or Issue of Rights Shares

If a Public company wants to increase its subscribed capital after the expiry of 2 years from the date of incorporation or after the expiry of 1 year from the first allotment of its shares, whichever is earlier, by allotment of further equity or preference shares, such further issue of shares must be offered prorate to the existing equity shareholders? Such shares are known as "Rights Shares" because they are offered to the equity shareholders as a matter of legal right, if a public company wants to avoid this legal right, it call do so by passing a special resolution to the effect. Similarly,

NOTES

any rights share not taken up by the existing equity shareholders may be disposed of by the directors as they think fit.

The Rights shares may be issued by part or at a premium and payable in one Lump sum or by installments. The issue of Rights Shares requires the sanction of the Controller of Capital issues who usually requires the issue to be made as premium. The law permits the utilization of premium amount to write off the rights issue expenses.

Illustration: 6 **(RIGHTS SHARES)**

Z Ltd, has an authorized capital of 3,000, 9% preference Share of Rs. 100 each and 70,000 equity Shares of Rs.10 each. All the Preference shares and 50,000 Equity Shares issued and fully paid as on 31st December 2004. As decided by the board of director, the company offered on 1st, March 2005, Rights shares and allotment in the market for Rs.30000 Rs.6000 was spent for the expenses of the issue. You are required to utilize the share premium account as permitted by law before passing journal entries to record the above transactions.

Solution

Hints: There are 50000 Equity Shares
1 new Share for every 5 shares held

Therefore = $\frac{50,000}{5}$ 10000 New share i.e.,

	Rights	Shares
On Application Rs.	7	8000 rights share taken up by existing equity
On Allotment Rs.	5	2000 rights Share sold to the public
	12	There is a premium of Rs. 2 per share
		* The allotment money is Rs. 3 (Rs.5 – Rs.2)

NOTES

2005 Mar 20	Bank A/c Dr. To Share Application A/c (being the application money received on 8000 rights shares at Rs. 7 from the existing equity shareholders)		Rs. 56,000	Rs. 56,000
Mar 31	Share Application A/c Dr, To share capital A/c Being the transfer of application money to share capital a/c.		56,000	 56,000
	Share Allotment A/c Dr. To Share Capital A/c (being the allotment money due on 8000 shares at Rs. 3 per share as per Boards Resolution dated)		24,000	 24,000
	Bank A/c Dr. To Share Allotment A/c To Share Premium A/c (being the amount due on allotment (Rs.3 and premium (Rs.2) received from the existing shareholders on 8,00 rights shares)		40,000	 24,000 16,000
	Bank A/c Dr. To Share Capital A/c To Share Premium A/c (being the 2000 rights shares sold for Rs.30000 $\frac{30000}{2}$ = Rs. 15 per share Face value = Rs.10 per share premium Rs.5 per share)		30,000	 20,000 10,000
	Share issue expenses A/c Dr. To bank A/c (being the issue expenses paid)		6,000	 6,000
	Share premium A/c Dr. To share issued expenses A/c (Being the issue expenses written off against share premium)		6,000	 6,000

NOTES

SHOW YOUR PROGRESS

1. Give Format for final accounts as per company act in 1956?

2. What is balance sheet of a company?

3. What do you mean by profit prior to incorporation?

4. Distinction between Right issue and bonus issues?

5. From the following Ledger Balances of a Company prepare the Profit and Loss A/c; Profit and Loss Appropriation a/c and Balance Sheet as on 31st December 2009 as per Schedule VI.

	Rs.		Rs.
Land and Buildings	900,000	S. Crs.	3,06,000
Plant and Machinery	16,56,000	Reserves	1,50,000
Office equipment	94,000	P/L a/c	
Furniture	36,000	(1.1.09)	88,000
Preliminary Expenses	49,000	Bank O/D	1,15,800
Calls in Arrears	25,000	Purchase Return	50,000
Cash in Hand	5,000	Sales	30,74,000
Investment(Face value		Share Capital	20,00,000
Rs.1,00,000)	98,800	6% Debts	10,00,000
Motor Van	30,000		
B/R	1,36,000		
Goodwill	1,60,000		
S. Debtors	2,08,000		
Purchases	24,00,000		
Sales returns	70,000		
Advertising	25,400		
Legal Charges	10,000		
Carriage inward	37,000		
Wages	2,32,000		
Rent paid	30,000		
Insurance	19,000		
Opening Stock	4,76,000		
Income Tax in advance	28,000		
Trade expenses	15,000		
Repairs to Buildings	3,000		
Repairs to machinery	5,600		
Interim Dividend paid	35,000		
	67,83,800		67,83,800

Adjustments:

a. Create a provision for Bad Debts at 5%.

b. Depreciate: Plant and Machinery 15%; Furniture 10%; Office equipment 10%; Motor van 20% and Buildings 5%.

c. Closing stock value Rs.5,42,000.

d. Provide for final dividend Rs.73,130.

e. Trade expenses include Rs.5,000 Audit Fees.

Ans: Gross Profit 4,51,000,Net Loss 39800,Balance sheet total 3620000.

6. 'A' Ltd. is a company with an authorized capital of Rs.5, 00,000 divided into 5,000 equity shares of Rs.100 each on 31-12-2009, 2,500 shares were fully called up. The following balances were extracted from the ledger of the company as on 31-12-2009:

	Rs.
Stock	
Sales	50,000
Purchases	4,25,000
Wages(Productive)	3,00,000
Discount allowed	70,000
Discount received	4,200
Insurance up to 31-03-2010	3,150
Salaries	6,720
Rent	18,500
General Expenses	6,000
Profit and Loss Account	8,950
Printing and Stationery	6,220
Advertisement	2,400
Bonus	3,800
Debtors	10,500
Creditors	38,700
Plant and Machinery	35,200
Furniture	80,500
Cash and Bank Balance	17,100
Reserve	1,34,700
Loan from Managing Director	25,000
Bad Debts	15,700
Calls in Arrears.	3,200
	5,000

NOTES

You are required to prepare Trading and profit and loss account for the year ended 31-12-2009 and the Balance Sheet as on that date. Additional Information: (a) Closing stock Rs.91,500; (b) Provide depreciation at 15% on Plant and Machinery and 10% on furniture. (c) Outstanding liabilities: Wages Rs. 5,200; Salary Rs.1,200; Rent Rs.600 (d) Provide 5% dividend on the paid-up share capital.

LESSON -8

VALUATION OF GOODWILL AND SHARES

NOTES

Meaning of goodwill:

an intangible asset valued according to the advantage or reputation a business has acquired (over and above its tangible assets)

8.1 Definition of Goodwill

Goodwill in simple words means the "good name" or the "reputation" of the business which attracts more customers and therefore, helps in earnings more profits in future. It is an intangible real asset and not a fictitious one. "It is perhaps the most intangible of intangibles".

Goodwill is a valuable asset if the concern is profitable. On the other hands, it is valueless if the concern is a losing one. Therefore, it can be stated that goodwill represents the value of the reputation of a firm. However, some of the definitions are discussed hereunder.

"The capacity of a business to earn profits in future is basically what is meant by the term goodwill" – J.O.Magee

According to the Institute of Chartered Accountants of India, goodwill is "an intangible asset arising from business connections or trade name or reputation of an enterprise."

NOTES

8.2 Nature of Goodwill

Goodwill is an intangible asset since it cannot be seen or felt. However, it is not fictitious in the case of profitable concerns. It can be sold, though a sale will be possible only along with the sale of business itself. Sometimes, goodwill is more valuable than the tangible assets.

8.3. Source of goodwill

The following are the main sources which generally give rise to goodwill:

1. The location of the business premises e.g., a retail shop located in a busy market centre.
2. The reputation of the articles sold arising from the high standard or quality of the goods themselves
3. Possession of trademarks patents or copyrights.
4. Possession of advantageous contracts or complete or partial monopoly.
5. Development of the business and shopping facilities with the changing conditions of the market e.g., provision for the visitors rest room
6. Any government or any legislative or any other special advantage enjoyed by the firm.

8.4. Need for valuing goodwill

1. When a new partner is admitted,
2. When a partner retires or dies ;
3. When there is a change in the profit sharing ratio;

4. When the business of a company is taken over by another company e.g., in case of amalgamation or absorption.
5. When the company's share is not quoted on the stock exchange and their value is to be determined for the purpose of estate duty and wealth tax etc.
6. When a person wants to purchase a large block of the company's shares with a view to acquire control over the management of the company
7. When the management wants to write back goodwill which it wrote off earlier to reduce or eliminate the debit balance in the profit and loss account.

NOTES

Methods of valuing goodwill:

1. Purchase of past profits
2. Capitalizati on of super-profits
3. Annuity based method
4. Purchase of super profit method

8.5 Methods of valuing goodwill

1. Purchase of past profits
2. Capitalization of super-profits
3. Annuity based on super-profits
4. Purchase of super – profits

8.5.1 Past profits Method

Goodwill is valued at an agreed number of year's purchase of the average annual profits of a given number of past years. In arriving at the profit all income and expenditure of an extraneous nature should be excluded. Where the profits of a business are continuously rising or falling, weighted Average method may be adopted.

NOTES

Illustration.1

The goodwill is to be calculated on the basis of three year's purchase of the average net profits for the preceding five years. The net profits for the 5 years were Rs.9,000, Rs.8,000, Rs.4,000, Rs.10,000 and Rs.9,000.

Solution:

Total profits for the preceding 5 years Rs.9,000 + Rs.8,000 + Rs.4,000 + Rs.10,000 + Rs. 9,000 = Rs.40,000

Average profit is Rs.40, 000/5 =Rs.8, 000

Value of goodwill = 8,000 X 3 += 24,000

8.5.2 Capitalization of super profits method

The excess or super – profits arrived at by deducting from the average net profits of the business, an allowance for the services of the proprietor and also interest on the tangible capital employed in the business at a rate appropriate to the class of business carried on. The amount of average super-profits is then capitalized at an assumed rate of interest and the capitalized amount becomes the value of goodwill.

Illustration-2

Average net profit is 16,000 p.a. The normal return on capital invested in such a business is 10% p.a. The net tangible assets employed in the business are valued at Rs.1,00,000. Find out the value of goodwill.

Solution

Average Annual profit	Rs. 16,000
Normal yield of the business	
Rs. 1, 00,000/100 X 10	Rs. 10,000

	6,000

Value of goodwill being the capitalized amount of Rs.6,000 at 10% Rs.60,000

8.5.3 Annuity Based on Super-profits method

This is a variation of previous method. That method assumes that the super-profits will be available for ever. This is not correct. Therefore, the present value of a terminal annuity of the super profits for a reasonable period is taken to calculate the value of goodwill.

NOTES

What is meant by Annuity?

Income from capital investment paid in a series of regular payments

Illustration-3

The net profits of the company for the past five years are:

Rs. 40,000; Rs.42, 000; Rs.45, 000; Rs.46, 000 and Rs.47, 000. The capital employed in the business is Rs. 4, 00,000 on which a reasonable rate of return of 10% is expected.

It is expected that the company will be able to maintain its super-profit for the next five years.

Calculate the value of an annuity of super profit taking the present value of an annuity for one rupee for five years at 10% interest as Rs.3.78.

NOTES

Solution

Total profit for 5 years = Rs.2,20,000

Average profits 2,20,000 / 5 = Rs. 44,000

Less: Reasonable return at 10% on Rs.4,00,000 = Rs. 40,000

4,000

Value of goodwill being present value of an annuity of super profits Rs.40,000 for 5 years at 10% (4,000 X 3.78)

8.5.4 .Purchase of super profit method

The value of goodwill is taken as equal to an agreed number of year's purchase of the average super profits. Thus, at 5 years purchase of the average annual super profits of Rs.40, 000, the goodwill would be amount to Rs.2, 00,000.

8.6. VALUATION OF SHARES

Numerous factors are considered for the valuation of shares. The rice prevailing on the stock exchange may be taken as the proper value. But it does not hold well in all cases. The prices are basically determined on the interaction of demand and supply and may not reflect a correct valuation on the basis of safety and yield. Further all the shares are not quoted on the stock exchange. The need for valuation of shares arises when 1. Shares relate to private limited companies, 2. Shares are unquoted; 3. Statues so require i.e., wealth Tax; 4. Formulating a scheme of amalgamation and absorption 5. Large block of shares is under transfer etc.

NOTES

Assets employed and earning power are the important factors in the valuation of shares. Generally, for a company to be liquidated assets will be the basis; where assets are not important, earning capacity will be the basis; in a going concern both may considered.

8.6.1 The methods of valuation of shares are

1. Net Assets Method
2. Earning capacity or Yield Methoa

1. Net Asset Method

An estimate of assets less liabilities appearing in the books of account and other liabilities not appearing in the accounts such as provision for taxation, arrears of preference dividend etc., is made. Depending on the circumstances, the goodwill may or may not be included. Non-trading assets also will be included. The assets will be considered at their market value. Preference shares, if any, preference share capital will be deducted. The balance will be divided by the number of equity shares in the company provided all shares are equally paid-up and the result will be the intrinsic value of the shares. If the company has equity shares of varying paid-up values, the total value should first be allocated to different paid up value groups and each such allocation would be divided by the number of shares in each groups.

NOTES

2. Assets basis may take the following forms

a. Break-up value or liquidation value. These terms suggest an amount to be received for the assets in this event of the company being wound up.

b. Book value: it is the original investment on the assets of the company less any allowance for depreciation.

Break-up value is used for companies incurring loss consistently over a number of years and having no prospect of recovery. Book value is used by wealth tax act for valuation of unquoted equity shares for companies other than Investment Company.

Illustration- 4

The following is the Balance sheet of ARK & Co. ltd.

Liabilities	Rs.	Assets	Rs
Share Capital 1,000 6%		Goodwill	70,000
pref.shares	1,00,000		
3,000 Eq.shares of	3,00,000	Plant & Machinery	1,50,000
Rs.100 each fully paid		Other Assets	3,25,000
General Reserve	30,000	Preliminary Expenses	30,000
5% Debentures	50,000		
Sundry creditors	95,000		
			5,75,000
	5,75,000		

1. Plant and machinery is to be depreciated by Rs.18,000
2. Goodwill is to be valued on the basis of average profit of the last five years.

   The profit for the past five years were:

   I Year 74,000

   II year 78,000

   III year 75,000

   IV year 77,000

   V year 76,000

   The debenture interest owes for one year

   Find out the value of Equity share.

Solution

Valuation of goodwill

$$\text{Average profit} = \frac{74{,}000 + 78{,}000 + 75{,}000 + 77{,}000 + 76{,}000}{5}$$

$$\frac{3,80{,}000}{5} = 76{,}000$$

Assets		
Goodwill	76,000	
Plant & Machinery	1, 32,000	
Other assets	3, 25,000	
		5, 33,000

NOTES

Less: Liabilities

Sundry creditors	95,000	
5% Debentures	50,000	
Debenture interest owing for one year	2,500	
		1, 47,500
		3,85,500

Net intrinsic worth

Net Assets	3,85,500
Less: preference share capital	1,00,000
	2,85,500
	30,000
	9,517
Worth of 1 preference Rs. 1, 00,000/ 1000	= Rs.100

Yield Method

An investor is primarily interested in the return on his investment. The price which he is prepared to pay directly varies with the expected yield. This valuation may be based on rate of return or on productivity factor. Again the rate of return may be rate of earning or rate of dividend. Rate of earning will be the basis for large block of shares, rate of dividend will be appropriate for small block of shares. The maintainable profit or the dividend for the company in the near future and the normal rate of earning or dividend for the company should be determined. Then capitalization factor should be determined. This factor will be applied to the maintainable profit of business

to arrive at the total value. If the yield expected is 12.5% in the market the capitalization factor would be 100/125 i.e. On this basis the value of an undertaking earning Rs. 3,00,000 p.a. would be Rs.3,00,000 X 8 = 24,00,000. The total value of the undertaking divided by the number of equity share gives the value for each equity shares. The same procedure is adopted for dividend yield basis.

Productivity factor is the earning power in relation to the value of assets employed for such earning. To arrive at the projected earning, the ratio given by the productivity factor is applied to the net worth of the business. This future estimated profit after making adjustments for depreciation, taxation, dividend on preference shares etc. shall be multiplied by the appropriate capitalization factor to arrive at the value of undertaking. The income from non-trading assets and the value of non-trading assets should be excluded in determine the maintainable profit and net worth of the business respectively.

Determination of Normal Rate of Return

The nature of investment would decide the rate of return. More risky investment would call for larger rate of return and low rate of return would be adequate for least risky investment.

Determination of future maintainable profits is a very complicated one as it involves both objective consideration of available information and subjective evaluation of many factors. Therefore due consideration should be given to all relevant factors.

NOTES

Average between assets valuation and yield method valuation

Really this is not valuation but it has it has been recognized in government circles for valuing shares of investment companies for wealth tax purpose. It is known as fair values.

The following formula also can be used to find out the market value of shares.

Market value = Dividend in terms of rupees / Normal rate of return X 100

Rate of return = profit earned / capital employed

Capital employed includes long term borrowings and the profit should be before debenture interest preference divided etc., but after income tax.

Illustration-5

Liberty Ltd. Gives the following particulars, find out the value of a share of Rs.100 on a) yield on capital employed basis and b) dividend basis, market expectation is 11%.

Year	Capital employed	Profit	Dividend (%)
1983	6,00,000	96,000	13
1984	9,00,000	1,80,000	17
1985	12,00,000	2,64,000	19
1986	20,00,000	5,00,000	20

Solution

NOTES

a) The yield on capital employed for each year and its weighted average is as follows:

Year	Yield on capital employed (%)	Weight	Product
1983	16	1	16
1984	20	2	40
1985	22	3	66
1986	25	4 10	100 222

b) The dividend rate on the simple average is 222/11 X 10 = Rs.20.18

The dividend rate on the simple average is

13+17+19+20

---------------- 69/4 = 17%.

4

Year	Rate	Weight	product
1983	13	1	13
1984	17	2	34
1985	19	3	57
1986	20	4	60

Average 184/10 = 18.4%

The values of share on the basis of dividend (weighted average) comes to

NOTES

LESSON-9

PROFIT PRIOR TO INCORPORATION

It may so happen that a company takes over a running business as from a certain date even though the company may come into existence at a later date. When final accounts are being prepaid for the first year we have to allocate the profits between the periods.

1. from the date of acquisition to the date of incorporation of the company and after the date of incorporation

# PROFITS PRIOR TO INCORPORATION	* PROFITS AFTER INCORPORATION

The profit earned prior to incorporation cannot be treated as earned by- the company as it has no legal existence then in the same sense any loss sustained prior to incorporation cannot be treated as a loss incurred by the company. What will happen to such a special profit or special loss?

Any profit earned prior to incorporation are to be transferred to capital Reserve A/c Since it is a capital profit the same will not be available for dividend. Any loss sustained prior to incorporation is to be added to goodwill A/c. This account may be written off over a period of years. If a goodwill a/c does not exist the loss should be added to preliminary expenses and written off over a period of time.

* Profit the later (i.e. after incorporation) period are revenue profits and therefore they are available for divided. The company may add therefore to the General Reserve it if so decides. If the company in our question is a public company them it cannot commence its business till it receives the Certificate of

Commencement of business. In the case, all profits earned before the receipt of the commencement certificate are treated as capital profits. Profit prior to incorporation. Means only the profits earned up to date of incorporation and not upto the date of the certificate of commencement of business. This demarcation is not strictly following.

NOTES

Method of Ascertaining pre and post incorporation profits.

If stock taken and valued on the day of incorporation and accounts balanced on that date, any profit or less sustained can be ascertained this is not done. Usually the first profits and loss account. In account is prepared for the whole years and as a result allocation is the basis of allocation is as follows:

Item to be apportioned * on the basis of

Item to be appointed	On the basis of
1. Gross profit	Turnover (Sales) Ratio
2. Rent Salary insurance printing & Stationary postage telephone depreciation (expenses dependent up on time)	
3. Carriage discount allowed advertisement traveler's Salaries and commission Brokerage (Expenses dependent upon sales)	Turnover (Sales) Ratio
4. Preliminary expenses director's fees debentures interest auditing (expense that arise only when the company comes into existence)	Wholly to the post incorporation period
5. Partners salary interest on Capital	Wholly to the post incorporation period

NOTES

Illustration: 1

A Company incorporated on 1st May 2009. Acquired a business with effect from 1st January 2009. The first accounts were drawn up to September 30, 2009.

The Gross profits is Rs. 56000

The General Expenses are Rs. 14220

Directors Remuneration Rs.1000 p.m.

Formation Expense amounted to Rs. 1500

Rent which till June 30, 2009 was Rs.100 p.m. as increased to Rs. 300 per annum from July 1, 2009. The manager of the earlier firm whose salary was Rs. 50 p.m. was made a director upon the incorporation and his remuneration thereafter is included in the figure of Director's Remuneration given earlier.

Prepare profits and loss accounts for the period assuming that the net sales were Rs.82000 the monthly average of which for the first four months of 2009 being one half of therefore the remaining period.

HINTS

(a) Gross profits

Let us suppose that the sales for the 4 months be represented by1, then the subsequent sales will be represented by 2

The number of months in the first period is 4 months and in the second period 5 the ratio is computed thus:

Pre-Incorporation 1x4	=	4
After Incorporation 2x5 =	10	Sales Ratio 4:10 or 2: 5
		14

Gross profits is to be apportioned in the Sales Ratio of 2:5
56000 x 2 / 7 = 16000
56000 x 5/7 = 40000
(b) General Expenses

These are to be apportioned on the Time Ratio

I.e. 4 months and 5 months 4:5

(1-1-09 to 30-4-09) (1-5-09 to 30-9-09) Time Ratio

Rs. 14220 x 4 / 9 = Rs. 6320

c) Director's Remuneration 5 months (to 30th September 2009) at Rs.1000 p.m. i.e. 5x1000 = Rs. 5000

The Manager's salary is Rs.2000 i.e. 4x Rs.500 p.m.

d) Formation expense completely to After incorporation period
e) Rent : 4 months at Rs.100 a month = Rs.400 (to 30th April 2009)
2 months at Rs. 100/- a month's plus 3 months at Rs. 250
a month's = 200 +750 = Rs.950 to 30th September 2009)

* Any profits earned prior to incorporation cannot be treated as profits earned by the company. As such, is ha to transferred to Capital A/c which will not be available for dividend.

NOTES

Solution:

PROFIT AND LOSS ACCOUNT FOR THE NINE MONTHS ENDED 30TH SEPTEMBER 2009

Dr. Cr.

PARTICULARS	Prior to incorporation Rs.	After incorporation Rs.	PARTICULARS	Prior to incorporation Rs.	After Incorporation Rs.
To General Expenses (4:5)	6320	7900	By Gross Profit (2:5)	16000	40000
To Director's Remuneration	-	5000			
To Manager's Salary	2000				
To formation expenses	-	1500			
To Rent	400	950			
To capital reserve	7280	-			
To net Profit		24650			
	16000	40000		16000	40000

Illustration: 2

NOTES

Mala Ltd was registered on 1st February 2009 to buy the business of Ms. Bala & Co., as on 1st October 2009 and obtained the certificate business on 1st March 2010. The accounts of company for the period ended 30th September 2010 disclosed the following results

1. Sales up to 1st February 2010 Rs. 40000
2. Sales after 1st February 2010 Rs. 200000
3. Trading A/c showed a Gross profit of Rs. 96000
4. The item under profit & Loss A/c were

	Rs.	
Director's Fees	1500	
Rent And Rates	4800	
Bank Debts	2000	(Which Rs.700 related before 1st February 2010)
Staff Salaries	12000	
Debentures interest	6000	
Depreciation	3000	
Preliminary Expenses	2400	
General Expenses	1800	
Commission on Sales	3600	
Printing and Stationery	4200	
Advertising	4200	
Traveller's Salaries	8400	
Interest on vendors	4000	
Auditor Fees		(as % on Rs.100000 from 1.10.04 to 31.05.05) 750

You have been asked to ascertain profit prior to incorporation and after incorporation.

NOTES

Statement showing the profit
Prior to incorporation & after incorporation

PARTICULARS	Ratio	Prior to incorporation Rs.		After Incorporation Rs	
Gross profit	(1:5)		16000		80000
Directors Fees				1500	
Rent and Rates	(1:2)	1600		3200	
Bad Debts (Before and After)		700		1300	
Staff Salaries	(1:2)	4000		8000	
Debentures Interest				6000	
Depreciation	(1:2)	1200		2400	
Preliminary Expenses				2400	
General Expenses	(1:2)	600		1200	
Commission on Sale	(1:5)	600		3000	
Printing and Stationery	(1:2)	800		1600	
Advertising	(1:5)	700		3500	
Traveller's Salaries	(1:5)	1400		7000	
Interest to Vendor	(4:4)	2000		2000	
Auditors Fees				750	
Capital Reserve Net Profit for the Period (Balancing Figure)		2400		36150	
		16000	16000	80000	80000

Illustration:3

NOTES

X Company Limited purchased a business on 1st April 2009. The company obtained certified to commence business on 31st July 2009. From the following particulars for the year ending 31st March 2010, ascertain profit prior to incorporation and divisible profits.

a. Total sales up to 31st March 2010 Rs.10,00,000. Sales from 1st April 2009 to 31st July 2009 Rs.2,50,000.
b. Gross profit for the year Rs.2,12,000.
c. Expenses debited to profit and loss account.

	Rs.
Rent	6000
Insuran	1,500
Salaries	27,000
Selling expenses	9,000
Advertisement	8,000
Interest on debentures	4,000
Audit fees	1,200
Printing and Stationary	4,200
Depreciation on Machinery	30,000
Commission on sales	12,600
Bad debts (Rs.850 related to prior to incorporation)	2,400
General expenses	4,800
Director fees	2,600
Preliminary expenses	7,200
Interest paid to vendors up to 1st September 2009	5,000

NOTES

Ans: **Calculation of profit Prior to Incorporation**

Particulars	Basis	Prior Incorporation		After Incorporation	
	Ratio	Debit	Credit	Debit	Credit
Gross Profit	Sales Ratio		53,000		1,59,000
Rent	Time Ratio	2,000		4,000	
Insurance	Time Ratio	500		1,000	
Salaries	Time Ratio	9,000		18,000	
Selling Expenses	Sales Ratio	2,250		6,750	
Advertisement	Sales Ratio	2,000		6,000	
Interest on Debenture	After	--		4,000	
Audit Fees	Time Ratio	400		800	
Printing/Stationery	Time Ratio	1,400		2,800	
Description on Machinery	Time Ratio	10,000		20,000	
Commission on Sales	Sales Ratio	3,150		9,450	
Bad Debts	Actual	850		1,550	
General Expenses	Time Ratio	1,600		3,200	
Directors Fees	After	--		2,600	
Preliminary Expenses	After	--		7,200	
Interest as Vendor	4 : 1	4,000		1,000	
Profit		15,850		70,650	
		53000	53000	159000	159000

Profit before Incorporation = Rs.15,850/-

Divisible Profit = Rs.70,650/-

Workings:

1. **Time Ratio (TR) :**

Date of Purchase	:	1 – 4 – 2009
Date of Commencement	:	31 – 7 – 2009
Date of year ending	:	31 – 3 – 2010

Therefore Time Ratio = 4 : 8 (or) 1 : 2

2. **Sales Ratio (SR) :**

Total Sales	:	10, 00,000
Up to Commencement	:	2, 50,000
After Commencement	:	7, 50,000

Therefore Sales Ratio = 25: 75 (or) 1 : 3

3. **Interest on Vendor :**

Up to 1^{st} September 2009 = 5,000

Before Incorporation = 4 months; after 1 month

Therefore 4: 1

NOTES

NOTES

LESSON-10

AMALGAMATION, ABSORPTION AND EXTERNAL RECONSTRUCTION

What is amalgamation?

The combination of two or more commercial companies

10.1. INTRODUCTION

Amalgamation, Absorption and External Reconstruction

The most important types of business organization are sole trader, partnership and Joint Stock Company. Quite often, individuals carry on business amalgamate them into a partnership some cases two partnership amalgamate into one firm. Amalgamations of this nature have already been discussed in your previous lessons. The amalgamation of joint stock companies is now dealt with in these lessons. The present age has witnessed two great development in business enterprise. The first is the growth O joint stock form of business organization.

The first is the tendency of combination in one form or other with varying degree of unification's. Various combinations were evolved out of the desire of the industrialists to secure the following objects:

1. Elimination of competition

2. Reduction of establishment and management charges and

3. Economy: on purchases of raw maintaining research organization Companies join together through amalgamation and absorption

10.2. Amalgamation

Suppose there are two companies. X and Y if a new company Z is formed to take over the business of both X and Y thee will be amalgamation. (It results in the liquidation of company X and Y). Thus, the companies agreeing to the scheme of amalgamation sell their business to a new company and go into liquidation. The new company takes over the business of the companies going into liquidation.

(i.e.) associated two or more companies combine to form a new company in order to affect economics as well as reducing the competition. Merging companies loss their identities.

NOTES

The advantage of amalgamation is...

1. Reduction in overhead expense, because, there will be one company in place two or more which have
2. Merged
3. Elimination of wasteful expenditure and competition is always possible
4. More capital can be obtained by way of public issue.
5. Economy in production and distribution in achieved by elimination of duplication of operations.
6. Unremunerative assets of the old companies can be usefully employed.
7. New object clause can be brought in as new company is being formed.

The disadvantages are

1. Old companies lose their identity and goodwill is also gone.
2. Retrenchment on account of amalgamation might be difficult to bring about
3. Change in management may not be welcomed the existing staff which my hamper smooth working
4. Past losses of the old companies which were eligible for tax relieve have now gone.

NOTES

10.3 Absorption

When an existing company acquires the business of another company the latter company into liquidation. There is absorption of the later company by the former one. i.e. there is merger of the later company into the first one. Suppose there are two companies A and B. If B takes over the business of a it will be Absorption. Here A company goes into liquidation (i.e.) the Western India Match Co. Ltd had ascribed a number of small match companies.

The advantages of absorption are

1. Economics of merger are possible, because of great efficiency and elimination of duplication of operations
2. Wasteful competition of resources is possible.
3. Better utilization of resources is possible.

The disadvantages are

1. One company losses its identity. There by depriving itself its goodwill.
2. Changed management may not be welcomed by the company absorbed and may hamper smooth working.
3. The shareholders of the company absorbed are generally at a loss in absorption.
4. Share capital could not be issued beyond the authorize capital increased and remitted by law.
5. Now object clause cannot be easily brought in.

What is the difference between Amalgamation and absorption?

NOTES

Both are form of combination of companies by means of merger. In both, amalgamation and absorption there is a merger. The difference is only in the kind of merger that take place. The merger may be unilateral or bilateral.

1. In amalgamation, merger is bilateral as two or more existing companies' merger together to form an altogether new company.

   In absorption, Merger is unilateral, as one existing company merger in and is absorbed by another existing company and no new company being formed.

2. In amalgamation - both the companies go into liquidation.

   In absorption - only the company which is being absorbed goes into liquidation.

10.4 Reconstruction

Let it be assumed that a company is running at a loss. It has accumulated its past losses. On account of such past losses, the company is in altering condition. Such on unsuccessful company goes into liquidation. Another company is formed to take over the existing assets and liabilities. By means of a scheme, the company is reconstructed so as to form a new company with precisely the same shareholders who have been asked to bring fresh working capital. Therefore Reconstruction of a company is called for when it is not in a position to carry on the business, because of the past losses in trading and financial difficulties resulting there from. Reconstruction literally means rebuilding something in a different from similarly reconstruction of a company implies altering the form of a company business and undertaking and running it in a different form. Instead of closing down a company for all times. It may be desirable to keep if going in altered form. So that the management and ownership have some kind of undertaking to sustain their interest.

NOTES

Reconstruction is two types

Reconstruction

External | Internal

10.4.1 External Reconstruction

Under External Reconstruction the company which is under reconstruction goes into liquidation and a new company is formed to take over the assets of the old the revised value. The creditors of the old company are offered terms of settlement under which they may be asked to accept Debentures. In full or part payment of the debt due to them. The shareholders of the old company are offered partly paid shares in the new company return for their holdings in the old company. The old company goes into liquidation. The new company is generally formed with the same or similar name with the same objects and is company of the same shareholders as the old company which is liquidated.

Though Absorption and Reconstruction processes resemble a sale by absorption the sale is effected to an existing company. The vendors are entitled to profit. On the other hand reconstruction is the sale of an existing company to a new one stated for that purpose. The losses are to be borne by the shareholders of the old company.

NOTES

10.4.2 Internal Reconstruction

Internal Reconstruction involved the re-organization of capital or re-arrangement of capital either sub-division of shares of consolidation of shares and does not involve liquidation. The company is not liquidated and there is no new company.

Reconstruction involves the rearrangement of capital by a compromise with the shareholders for alteration of capital between each class and compromise with creditors and debenture holder. This is case of internal Reconstruction it is almost the reduction of capital.

Internal reconstruction will be discussed in next chapter.

What is purchase consideration?

When a purchasing company takes the business of a selling company, it was to pay consideration of price to the liquidated company. That consideration or price is called purchase consideration.

10.4.3 PURCHASE CONSIDERATION

When a purchasing company takes the business of a selling company, it was to pay consideration of price to the liquidated company. That consideration or price is called purchase consideration.

Method of Calculation: 1. Net Payment Method

In all the question where net payment method is adopted. The student has simply to add the payment to be made by the purchasing company. The following rules are adopted. a) Add all the payments whether in cash, shares or debentures

b) Add all the payments to the vendor company whether made for shareholders creditors debenture holders liquidation expense.

c) Leave out all the payment made by the purchasing company to some other party on behalf of the vendor company.

NOTES

d) Do not add or deduct the liabilities taken over by the purchasing company.

2. Net Asset Method

When the full details of purchase consideration (as discussed above) are not given the purchase consideration should be calculate by adding the agreed value of only those assets which have been taken over by the purchasing company and deducting therefore the agreed value of only those liabilities which have been taken over the purchasing company. It may be noted the net asset method adopted only when the first method cannot be adopted.

3. Intrinsic Value of Shares

AS a slight variation from net asset method, sometimes student may be asked to calculate the intrinsic value of shares of both the companies and determine the ration of exchange of the share between the buying and selling companies. It be understood that the purchases consideration is still equal to the net assets of the selling company. The additional feature is the valuation of shares of the purchasing company on net assets basis for the purpose of allotment to the shareholders of the selling company.

4. Net Payment and Net Asset Method

Although the purchase consideration is based either on the net both. In such cases the purchases price calculated by both methods must be equal where they are not equal one has to make the adjustment of the issue price of the share of the purchasing company. If the purchase price is more by the assets method, t hen the issue price will be at premium and where it is less, the issue price will be at discount.

NOTES

Example: 1

Murugan Ltd Absorbed Velan Ltd. The Balance Sheet of Velan ltd is as follows.

Liabilities		Asset	
	Rs.		Rs.
Share Capital			
200, 7% preference Shares of Rs.100 each fully paid	20,000	Sundry Assets	1,30,000
500 Equity Shares of Rs.100 each fully paid	50,000		
Reserve	20,000		
Profit and Loss A/c	10,000		
7% Debentures	20,000		
Trade Creditors	10,000		
	1,30,000		1,30,000

Murugan Ltd has agreed

1. To issue to the debentures in Velan Ltd 10% Debentures at Rs.100 in lieu of 7% Debentures in Velan Ltd

2. To issue 8% preference Shares of Rs.100 each in the radio of 4 shares in Velan Ltd For 5 shares in Velan ltd

3. To exchange 5 Equity shares of Rs.100 each at the market price of Rs.120 per share for every 4 shares in Velan Ltd and to pay Rs.25 shares in cash and

4. To take over the trade creditors. Calculate purchase consideration.

NOTES

Answer

Purchase consideration:

		Amount (Rs)	From
i) Debentures holders		20,000	7% Debentures
ii) Preference shareholders	200 x 4/5 x 100	16,000	8% Pref. Shares
iii) Equity shareholders	200 x 4/5 x 100	75,000	Equity share cash
	500 x 25	12,500	
	Total	1,23,500	

Example: 2

Senthil Ltd Decides to absorb Nagaraj Ltd. The Balance Sheet of Logu Ltd is as follows.

	Rs.		Rs.
3,000 Equity Shares of Rs.10	30,000	Sundry Assets	28,000
each fully paid		Preliminary Expenses	1,000
Creditors	5,000	Profit and Loss A/c	6,000
Total	35,000	Total	35,000

Senthil Ltd Agrees to take over only the assets of Nagaraj Ltd For purpose of absorption an equity share in Nagaraj Ltd is valued at Rs.8 Raman Ltd. Agrees to pay Rs.5, 000 in cash for payment to creditors and the balance in the form of its equity shares of Rs.10 each at the market value of Rs.15. Calculate purchases consideration.

Answer

NOTES

Purchase consideration	Rs.
Value of 3,000 shares of Nagarj Ltd @ Rs.8	24,000
Add: Cash paid for payment to creditors	5,000
	29,000

Number of shares in Raman Ltd. To be issued to Nagaraj Ltd

$$= \frac{24,000}{15} = 1,600$$

Example : 3 (Intrinsic Value Method)

The following are the balance sheet of X Ltd and Y Ltd as on 31.03.2005.

X Ltd

Liabilities	Rs.	Asset	Rs
Share Capital - 20,000	2,00,000	Fixed Assets	3,50,000
Share of Rs.10 each	4,00,000	Current Assets	3,00,000
Debentures	1,75,000	Investments	2,50,000
Current Liabilities	1,25,000		
	9,00,000		9,00,000

NOTES

Y Ltd

Liabilities	Rs.	Asset	Rs.
Share Capital - 9,000	90,000	Fixed Assets	1,50,000
Share of Rs.10 each	59,000	Current Assets	1,00,000
General Reserve	40,000		
P & L A/c			
Current Liabilities	70,000		
	2,50,000		2,50,000

X Ltd agreed to take over Y Ltd. Find out the ratio of exchange of share on the basis of the intrinsic values.

Answer: 1) Calculation of intrinsic value of shares

	X LTD	**YLTD**
Assets	**Rs**	**Rs**
Fixed Assets	3,50,000	1,50,000
Investments	2,50,000	
Current Assets	3,00,000	1,00,000
	9,00,000	2,50,000

NOTE

Less : Liabilities	Rs		
Debentures	1,75,000		
Current Liabilities	1,25,000	3,00,000	70,000
Net Assets		6,00,000	1,80,000

$$\text{Intrinsic value of shares} = \frac{60,000}{20,000} \qquad \frac{1,80,000}{9,000}$$

$$= \text{Rs. } 30 \qquad = \text{Rs. } 20$$

This can be done in two ways. The first method is to calculate the L.C.M of the intrinsic values of shares and the amount so obtained is divided by the intrinsic values to arrive at the ratio of exchange.

L.C.M of Rs. 30 and Rs. 30 and Rs. 20 is Rs. 60

2 share of X Ltd will be equal to Rs. 60

3 shares of Y Ltd will be equal to Rs. 60 Consequently, the ratio of exchange is two shares of X Ltd for every three of Y Ltd Shares.

Alternatively, divided the net assets of Y Ltd by intrinsic value of the share of X Ltd to determine the number of shares to be issued on the basis of which the ratio of exchange can be determined.

$$\frac{\text{Net Assets of Y Ltd}}{\text{Intrinsic value of the shares of X Ltd}} \qquad \frac{\text{Rs. } 1,80,000}{\text{Rs. } 30} = \text{Rs. } 6000$$

$$\text{Number of shares of X Ltd to be issued} \qquad \frac{\text{Rs. } 1,80,000}{\text{Rs. } 20} = \text{Rs. } 9000$$

NOTES

Illustration: 1

Kavitha & Co and Ranjani & Co Ltd Agree to amalgamate. A New Company called Swarna Co Ltd is registered to take over the business of both these companies. The following is their Balance Sheets.

Balance Sheet of Kavitha & Co. Ltd

	Rs.		Rs.
Paid-up Capital			
900 Share of Rs.270 each	2,43,000	Sundry Assets	3,22,300
General reserve	63,000	Investment on	
		Compensation Fund	20,000
Profit and Loss A/c		Cash	700
Undistributed Balance	6,000		
Accident Compensation Fund	20,000		
Insurance Reserve	3,000		
Working Saving Bank	2,300		
Unclaimed Dividend	700		
Bill's Payable	5,000		
	3,43,000		3,43,000

NOTES

Balance Sheet of Ranjani & Co Ltd

	Rs.		Rs.
Paid-up Capital			
4,000 Share of Rs.270 each	8,00,000	Sundry Assets	8,50,000
Capital reserve		Sinking Fund Investments	5,000
Contingency Reserve	7,000	Bank	21,000
Dividend Equalisation Fund	20,000	Profit & Loss A/c	4,000
Sinking Fund	5,000	(Accumulated Loss)	
Working's Profit sharing Fund	2,000		
Sundry Creditors	41,000		
Employee's Provided Fund	5,000		
	8,80,000		8,80,000

Show how the payment of Kavitha & Co., Ltd., and Kalpana & Co., Ltd., is arrived at and prepare the amalgamated sheet of Swarna & Co., Ltd.,

NOTES

Solution:

The question does not state what is the actual purchases consideration of the concerns of how is to be arrived at. Under these circumstances. It may assume to be equal to the net value of each business unit.

Statement showing the Amount

Payable to each of the Amalgamated Companies

1. *Kavitha & Co., Ltd.,*		Rs.
Assets taken over		322300
Sundry Assets		20000
Investment on Compensation fund cash		700
Cash		343000
Less: Liabilities taken over:		
Workmen's saving bank	2300	
Unclaimed Dividend	700	
Bills payable	5000	8000
		335000
2. Ranjani & Co. Ltd.,		
Assets taken over		Rs.
Sundry Assets		850000
Sinking Fund investments		5000
Bank		21000
		876000

Less : Liabilities taken over :

Workmen's saving bank	2000	
Unclaimed Dividend	41000	
Employee's Provident Fund	5000	48000
		828000

The purchases Consideration of Kavitha & Co., Ltd., Rs. 335000

The Purchases Consideration of Ranjani & Co., Ltd., Rs. 828000

Balance Sheet of Swarna Co., Limited

(Amalgamated Balance Sheet) As At...

Liabilities	Rs	Asset	Rs
Share Capital : Authorized * issued & Subscribed shares of Rs. Each Current, Liabilities & Provision : Bills payable (Kavitha Ltd.) Sundry Creditors (Ranjani Ltd) Unclaimed Dividend (Kavitha Ltd) Workmen's Savings Bank (Kavitha Ltd.) Workmen's Profit Sharing Fund (Ranjani Ltd.) Employee's Provident Fund (Ranjani Ltd.	11,63,000 5,000 41,000 700 2,300 2,000 5,000	Fixed Assets : Sundry Assets (3,22,300+ 8,50,000 Investment on compensation Fund Sinking Fund Investment (Ranjani Ltd.) Current Assets, Loans & Advances Cash (Kavitha Ltd.) Bank (Ranjani Ltd.)	11,72,300 20,000 5,000 700 21,000
	12,19,000		12,19,000

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Illustration: 2

'X' Ltd., and 'Y' Ltd., have agreed to amalgamate. A new company "Z" Ltd., has been formed to take over the combined concern as on 31st December 2009. After negotiation, the assets of the two companies have been agreed as shown in the following balance sheets.

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
Share Capital			Land and Buildings	3,00,000	5,00,000
In Rs. 10 each	5,00,000	10,00,000			
Reserve Fund	50,000	-	Plant & Machinery	2,50,000	2,00,000
Profit Loss A/c.	50,000	50,000	Goodwill	50,000	-
Creditors	50,000	80,000	Patents	-----	1,10,000
			Stock	-----	1,50,000
			Sundry Debtors	20,000	1,20,000
			Bank	10,000	50,000
	6,50,000	11,30,000		6,50,000	11,30,000

The assets and liabilities will be taken over by 'Z' Ltd., It issued 50,000 shares of Rs. 10 each to the public for raising working capital. Assuming purchase price is to be settled in fully paid shares of Rs. 10 each, compute the purchase consideration payable. Given journal entries and Balance sheet of "Z" Ltd.

31.12.09	Business Purchase A/c To Liquidator of 'X' Ltd., To Liquidator of 'Y' Ltd., (Being Purchase price payable to X and Y companies)	16,50,000	 6,00,000 10,50,000
	Land & Building A/c. Dr. Plant & Machinery A/c.Dr. Patents Account Dr. Stock A/c Dr. Sundry Debtors A/c Dr. Bank A/c Dr. Goodwill A/c Dr. To Creditors A/c To Business purchase A/c (Being assets and liabilities taken over of X and Y Companies)	8,00,000 4,50,000 1,10,000 1,70,000 1,40,000 60,000 50,000	 1,30,000 16,50,000
	Bank A/c Dr. To Share capital A/c (Being shares issued to the public)	5,00,000	 5,00,000
	Liquidator of X Ltd. A/c. Dr. Liquidator of Y A/c. Dr. To share capital A/c. (Being purchase price paid in the form of fully paid shares)	6,00,000 10,50,000	 16,50,000

NOTES

NOTES

Ans: Statement showing purchase consideration

	X Ltd.,	Y Ltd.,
Total assets as agreed	6,50,000	11,30,000
Less: Creditors	50,000	80,000
Net assets payable as purchase consideration	6,00,000	10,50,000

Balance sheet of 'Z Ltd., as on 31.12.2009

Liabilities	Rs.	Assets	Rs.
Share capital:		Goodwill	50,000
2,15,000 share of		Land & Buildings	8,00,000
Rs. 10 each fully paid	21,50,000	Plant & Machinery	4,50,000
Creditors	1,30,000	Patents	1,10,000
		Stock	1,70,000
		Sundry Debtors	1,40,000
		Bank	5,60,000
	22,80,000		22,80,000

NOTES

Illustration: 3

The following are the balance sheets of 'S' Ltd., and 'P' Ltd., as on 31st March 2010

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
Share Capital			Fixed Assets	1,20,000	2,50,000
Share of Rs. 10 each	1,00,000	2,00,000	Loan to P Ltd.,	10,000	-
Reserve fund	40,000	60,000	Debtors	30,000	20,000
Workmen's Compensation fund	10,000	-	Stock	20,000	30,000
Creditors	30,000	40,000	Cash	-	10,000
Loan form 'S' Ltd.,	-	10,000			
	1,80,000	3,10,000		1,80,000	3,10,000

'P' Ltd., agreed to absorb 'S' Ltd., on the following terms:

1) 'P' Ltd., shall give one share of Rs. 35 each for every three shares in 'S' Ltd., The share of P Ltd., are quoted in the market at Rs. 45 pler share.
2) The stock of 'S' Ltd., stock worth Rs. 15,000 purchased from P Ltd., which was sold at a profit of 20% on cost.

NOTES

3) Creditors of 'S' Ltd., include Rs. 5,000 due to 'P' Ltd., Give ledger accounts in 'S' Ltd to close the books and journal and balance sheet in the books of P Ltd.,

Ans: Working Note:

Number of shares in S Ltd.,	=	$\frac{1,00,000}{10}$	=	10,000
Share to be received from P Ltd.,	=	$\frac{10,000}{3}$	=	3,333.33
Value of shares to be received	=	3,333 x 35	=	1,16,655
Cash for fractions, at market value	=	45 x 1/3	=	15
Total purchase consideration =				1,16,670

Market Value is taken only to value the fraction.

For the shares to be issued, agreed value along should be taken.

Books of S Ltd., (Selling Company)

NOTES

Realization A/c

Particulars	Rs.	Particulars	Rs.
To fixed assets	1,20,000	By Creditors	30,000
To loan to 'P' Ltd.,	10,000	By 'P' Ltd.,	1,16,670
To Debtors	30,000	By shareholders (loss)	33,330
To stock	20,000		
	1,80,000		1,80,000

Shareholders A/c.

Particulars	Rs.	Particulars	Rs.
To realization A/c (Loss)	33,330	By Shares capital	1,00,000
To shares in 'P' Ltd.,	1,16,655	By Reserve fund	40,000
To cash	15	By workmen Compensation fund	10,000
	1,50,000		1,50,000

Particulars A/c

Particulars	Rs.	Particulars	Rs.
To realization A/c (Loss)	1,16,670	By Shares in P. Ltd.,	1,16,655
		By Cash	15
	1,16,670		1,16,670

NOTES

	Business Purchase A/c To Liquidator of 'S' Ltd., (Being Purchase price payable)	1,16,670	 1,16,670
	Fixed Assets A/c. Dr. Loan to P Ltd., A/c. Dr. Debtors Dr. Stock A/c Dr. To Creditors A/c To Business purchase A/c To Capital Reserve A/c. (Being assets and liabilities taken)	1,20,000 10,000 30,000 20,000	 30,000 1,16,670 33,330
	Loan from S Ltd A/c. Dr. To Loan to P Ltd., A/c. (Being loan from S Ltd., set off against asset acquired)	10,000	 10,000
	Creditors A/c. Dr. To Debtors A/c. (Being mutual obligation included in creditors and debtors eliminated)	5,000	 5,000
	Capital reserve A/c Dr. To stock A/c (Being profit at 2/ 120 on Rs. 15,000 Stock received from S. Ltd.,)	2,500	 2,500
	Liquidator of S Ltd., A/c Dr. To share Capital A/c. (3,333 x 10) To share premium A/c (3,333 x 25) To Cash A/c. (Being purchase price paid in the form of shares at premium and cash)	1,16,670	 33,330 83,325 15

Balance Sheet of P Ltd., as on 31.03.2010

NOTES

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
Share Capital			Fixed Assets	2,50,000	
23,333 share of			Add : Acquisition	1,20,000	3,70,000
Rs. 10 each		2,33,330		30,000	
Reserve fund		60,000		30,000	
Capital Reserve		-	Debtors	50,000	
(33,330 – 2,500)		30,830	Less: Acquisition		
Share premium		83,325		5,000	45,000
Creditors	40,000			30,000	
			Add: Mutual		
Add: Acquisition	30,000	-	Obligation		
	70,000			17,500	47,500
			Stock		
Less: Mutual					
Obligation	5,000	65,000		10,000	
			Acquisition		
Loan from S Ltd.,	10,000				9,985
			(20,000 – 2,500)		
			Cash	15	
Less: Mutual	10,000	-			
			Less: Paid to S Ltd.,		4,72,485
Obligation					
		4,72,485			

NOTES

Illustration: 4

On 1-1-2010 balance sheet of H Ltd., was as follows:

Liabilities	Rs.	Assets	Rs.
Share capital		Goodwill	40,000
5,000 6% pref. shares		Patents	15,000
Of Rs. 10 each fully paid	50,000	Other Assets	1,64,500
15,000 equity shares		Cash	500
Of Rs. 10 each	1,50,000	P & L Account	28,000
6% Debentures	30,000	Preliminary Expenses	2,000
Creditors	20,000		
Pref. Dividends in			
Arrears for 4 years	-		
	2,50,000		2,50,000

A scheme of reconstruction was proposed and agreed as follows:

1. A new co., J Ltd., with an authorized capital of Rs. 3,25,000 all in equity share of Rs. 10 each was to be formed
2. One equity share, Rs.5 paid to be issued for each equity share in the old company.
3. Two equity share of Rs. 5 paid in the new co., to be issued for every pref. share in old company.
4. Arrears of pref. Dividend to be cancelled
5. Debentures in old co., to receive 3,000 equity shares in the new co., credited as fully paid.
6. Creditors to be taken over by new company.
7. Remaining unissued shares to be taken up and paid for in full by the directors.
8. The new co., to take over the old Co's assets except patents subject to writing down other assets by Rs. 35,000
9. Patents were realized by old co., for Rs. 1,000

Open the books of J Ltd., by means of journal entries and give balance sheet of J Ltd., Expenses of H Ltd., came to Rs. 1,000

NOTES

Working Note: Statement showing purchase consideration

Particulars	Shares to be issued
For Equity shareholders:	
15,000 x 5	75,000
For Pref. shareholders	
5,000 x 2 x 5	50,000
For Debenture holders	
3,000 x 10	30,000
Purchase consideration	1,55,000

Books of J Ltd., (Purchasing company)

Date	Particulars	Rs.	Rs.
1.1.2010	Business Purchase A/c. Dr.	1,55,000	1,55,000
	To Liquidator of H Ltd.,		
	(Being purchase price payable)		
		1,29,500	
	Other assets A/c. Dr.	500	
	Cash A/c Dr.	45,000	
	Goodwill A/c (Balance) Dr.		20,000

NOTES

	To Creditors A/c.		1,55,000
	To Business purchase A/c		
	(Being assets and liabilities taken over and goodwill thereon)		
	Bank A/c Dr.	45,000	
	To Equity share Capital (fully paid) A/c.		45,000
	(being shares issued to the public)		
	Liquidator of 'H' Ltd., A/c. Dr.	1,55,000	
	To equity share Capital (Rs. 5 paid) A/c.		1,25,000
	To equity share Capital (fully paid) A/c.		30,000
	(Being settlement of purchase price by issue of fully paid and partly paid shares)		

NOTES

Balance sheet of J Ltd., as on 1-1-2010

Liabilities	Rs.	Assets	Rs.
Share capital		Goodwill	45,000
7,500 equity share of		Other Assets	1,29,000
Of Rs. 10 each fully paid	75,000	Bank	45,000
25,000 equity shares		Cash	500
Of Rs. 10 each Rs. 5 paid	1,25,000		
Creditors	20,000		
	2,20,000		2,20,000

Note 1 : There is no need for any entry for cancellation of areas of preference dividend.

Note 2: Debenture + Public=7500 (3000+4500) Fully Paid

Note 3: Partly paid=Equity shares + Preference Share (15000+10000) =25000

NOTES

Illustration: 5

The Balance Sheet of two companies is as follows:

Pai Co.Ltd

	Rs.		Rs.
Authorized Capital :		Sundry Assets	3,22,000
1,000 share of Rs.300 each	3,00,000	Bank Balance	1,000
Subscribed Capital :			
900 Share of Rs.270 each	2,43,000		
Reserve Fund	72,000		
Bills Payable	8,000		
	3,23,000		3,23,000

Shenoy Co., Ltd.

	Rs.		Rs.
Authorised Capital :		Sundry Assets	8,46,000
6,000 shares of Rs.200 each	12,00,000	Bank Balance	30,000
Subscribed Capital :			
4,000 Shares of Rs.150 each	6,00,000		
	2,28,000		
Profit & Loss A/c	48,000		
Creditors	8,76,000		8,76,000

It was proposed that PAI Co., Ltd should be absorbed by SHENOY Co., and the following arrangement was accepted. The holder of every 3 shares in PAI Co., Ltd was to receive 5 shares in the SHENOY Co. Ltd., Plus as much cash is necessary to adjust the rights of shareholders of both the companies in accordance with the intrinsic value of the shares as per their balance sheet. Pass the necessary Journal, Entries in the book of the SHENOY Co., Ltd and prepare the new Balance Sheet giving effect to above scheme of absorption.

Solution

1. Intrinsic value of shares in Pai Co. Ltd., **Rs.**

Total Assets	-	3, 23,000
Less: Liabilities	-	8,000
Worth of 900 shares		------------
		3, 15,000

Each share worth of = $\frac{3,15,000}{900}$ Rs.350

Intrinsic value of share in SHENOY Co. Ltd., **Rs.**

Total Assets	-	8, 76,000
Less: Liabilities	-	48,000
Worth of 4000 shares		------------
		8, 28,000

Each share worth of = $\frac{8,28,000}{4000}$ Rs.207

The holder of every 3 share issue paid Co., Ltd was to receive 5 shares in the SHENOY Co. Ltd., at their intrinsic value + the difference in cash. Therefore the amount of cash payable is.

Intrinsic values of 3 shares in PAI Co., Ltd at Rs.350 per share – 1,050

NOTES

Less: intrinsic value of 5 shares of SHENOY Co. Ltd., Rs. 207 per share – 1,035
At Cash payable 15

Cash payable is Rs.15 per 3 shares, So cash payable is Rs.5 per share.
In PAI Co., Ltd there are 900 shares. For every 3 shares of SHENOY Co. Ltd., will be issued therefore = 900/3 X 5 = 1,500 Shares

The paid up value of each share Rs.150 in SHENOY Co. Ltd., The value of the above shares will be

		Rs.
= 1,500 x Rs.150	=	2, 25,000
Cash payable Rs.5 per share on 900 shares Of PAI Co., Ltd i.e., 900 x Rs.5	=	4,500
Purchasers Consideration		2, 29,500

	Particulars	L.F	Dr Rs.	Cr. Rs.
	Business Purchases A/c. Dr. To PAI Co.Ltd A/c(being the purchase consideration due as per agreement dated)		2,29,500	2,29,500
	Sundry Assets A/c Dr. Bank A/c Dr. To Bills Payable A/c To Business purchases A/c To capital Reserve A/c (Being the various assets and liabilities brought into account and the difference credited to Capital Reserve A/c.)		3,22,000 1,000	8,000 2,29,500 85,500
	Liquidator of Paid Co. Ltd Dr. To share Capital A/c (being the issue of 1,500 shares of Rs.150 each and Rs.4,500 in cash in full satisfaction of the purchases consideration)		2,29,500	2,29,500

NOTES

New Balance Sheet of shenoy Co., Ltd.

Liabilities	Rs.	Assets	Rs.
Share Capital :			
Authorized :	12,00,000	**Fixed Assets:**	
6,000 shares of Rs.200 each		Sundry Assets	11,68,000
Issued & subscribed		(Rs.8,46,000 + 3,22,000)	
5,500 shares of Rs.150 each	8,25,000	Bank (Rs.30,000 + 1,000 Minus Rs.4,500)	26,500
Reserve & surplus			
Capital Reserve	85,500		
Profit & Loss A/c	2,28,000		
Current Liabilities & Provision			
Bills Payable	8,000		
Creditors	48,000		
	11,94,500		11,94,500

NOTES

Illustration : 7 **(Absorption)**

The following is the Balance Sheet of Tip and Top Co., Ltd on 31st December 2009.

Balance Sheet of Tip And Top Co., Ltd At at 31st December 2009

Liabilities	Rs.	Asset	Rs.
Capital:		Sundry Assets	3,79,000
9,000 Equity shares of Rs.10 each	2,00,000	Cash in hand	1,000
6% Debentures	1,00,000		
Sundry	30,000		
Reserve Fund	25,000		
Profit & Loss	25,000		
	3,80,000		3,80,000

The company is absorbed by Black and White Co., Ltd on that date.

The consideration for the above absorption is the discharge of debentures at a premium of 5 percent taking over the liability in respect of sundry creditors and a payment of Rs.5 cash and one share of Rs.5 in the Black and white co. Ltd at the market value of Rs.8 per share in exchange for one share in Tip and Co., The cost of liquidation of Rs.500 is to be met by the purchasing company. A divided of 10%

of the shareholders of Black and white Co. Ltd to be declared prior to the absorption paid. The paid up capital is Rs.2,00,000.

NOTES

Draft the journal Entries in the book of both the companies

Hints: 1. Purchase consideration is calculated like this:

Discharge of Debentures		Rs.	Rs.
6% Debentures		1, 00,000	
At a premium of 5% on Rs.1, 00,000		5,000	
		----------	1, 05,000
Issue of Shares:			
One share in Black and white co., Ltd for every share			
in tip and top co., Ltd there are 20,000 shares in		1,00,000	
Tip and Top co., Ltd. 20,000xRs.5 worth of share at Rs.8/-			
20,000 x Rs. 3 premium	60,000	1,60,000	
Cash :Payment at Rs.5 per share 20,000 x 5		1,00,000	

Purchase consideration		3,65,000	
		----------	

3. Dividend paid at 10% on Rs.2,00,000=2,0000x10/100 =20000

NOTES

Solution : In the Books of Tip and Top Co., Ltd.

Date	Particulars		Dr.	Cr.
2009			Rs.	Rs.
Dec	Realisation A/c Dr.		3,80,000	
31	To sundry Assets A/c			3,79,000
	To cash A/c			1,000
	(Being the various assets transferred to Realisation A/c)			
	Sundry Creditors A/c. Dr.		30,000	
	To Realisation A/c			30,000
	(being the liability transferred to Realisation A/c)			
	Black and white Co., Ltd A/c Dr.		3,65,000	
	To Realisation A/c			3,65,000
	(being the purchase consideration due as per agreement dated)			

	Shares in Black & white Co Ltd. A/c Dr. Cash A/c Dr. To Black & white co., Ltd.,A/c (being the purchase consideration duly received by way if shares worth of Rs.1,60,000 and the balance in capital)		1,60,000 2,05,000	3,65,000
	Black &white Co. Ltd A/c Dr. To cash A/c (being the liquidation expenses to be met by purchasing company)		500	500

NOTES

In the Books of Tip and Top Co., Ltd

Date	Particulars	Dr.	Cr.
	Cash A/c Dr. To Black and white co. Ltd A/c (being the receipt of the amount of liquidation expenses from the purchasing company)	500	500
	Debentures Dr. Realisation A/c Dr. To debenture holders A/c	1,00,000 5,000	1,05,000

NOTES

	(being the amount due to debentures holders at a premium of 5% on Rs.1,00,000 and the Realisation A/c)		
	Debentures holders A/c Dr. To cash A/c (being the debentures holders paid off)	1,05,000	 1,05,000
	Equity Share capital A/c Dr. To Equity Share holders A/c (being the share capital account closed and transferred to share holders A/c)	2,00,000	 2,00,000
	Reserve fund A/c Dr. Profit & Loss A/c To Equity share holders A/c (being the accumulated profits transferred to the later account)	25,000 25,000	 50,000
	Realisation A/c Dr. To Equity Share Holders A/c (being the profit on realization transferred to the latter A/c)	10,000	 10,000

	Equity Shareholders A/c Dr To shares in Black and white Co. Ltd A/c To Cash A/c (being the equity shareholders paid off)	2,00,000	 1,60,000 40,000

NOTES

IN THE BOOKS OF BLACK AND WHITE CO., LTD

DATE	PARTICULARS	Dr.	Cr.
2009	Profit & Loss appropriation A/c Dr. To Dividend A/c (being the dividend payable 105 on Rs.2,00,000 as per Resolution Dated)	**Rs.** 20,000	**Rs.** 20,000
	Dividend A/c Dr. To Bank A/c (being the payment of dividend to shareholders before absorption	20,000	 20,000
	Business Purchases A/c Dr. To liquidation Tip and top Co., Ltd A/c (being the purchase consideration due as per agreement dated)	3,65,000	 3,65,000

NOTES

	Sundry Assets A/c Dr.	3,79,000	
	Cash A/c Dr.	1,000	
	Goodwill A/c Dr.	15,000	
	To sundry creditors A/c		30,000
	To Business Purchase A/c		3,65,000
	(being the various assets liabilities brought into account and the difference Rs.3,80,000 debited to Goodwill A/c		
	Liquidation if Tip and Top Co Ltd., A/c Dr.	3,65,000	
	To Cash A/c		2,05,000
	To share capital A/c		1,00,000
	To share premium A/c		60,000
	(being the issue of 20,000 shares of Rs.5 at Rs.8 and Rs.1,00,000 in cash in full satisfaction of the purchase consideration)		
	Goodwill A/c Dr.	500	
	To cash A/c		500
	(being the expenses of liquidation Tip and Top debited to goodwill A/c)		

Realization A/c

Dr. Cr.

	Rs.		Rs.
To sundry Assets	3,79,000	By sundry Creditors	30,000
To cash A/c	1,000	By Black and white Ltd	3,65,000
To Debentures Holders A/c	5,000		
To Equity Share Holders A/c (profit)	10,000		
	3,95,000		3,95,000

Inter Company Debits of Mutual indebtedness in Cases of Merger:

It is a well know fact the absolutely stranger companies are not merged. Usually amalgamation or absorption takes place in – between companies which have connections or dealing. Therefore it is quite common to find inter – company indebtedness in cases of merger.

Selling company may be indebted to purchasing Company or vice versa through Purchases and sales. Such mutual indebtedness must be eliminated by passing set off entries in the books of the purchasing company. In case of Sundry Debtors and Sundry Creditors Accounts names of Purchasing Company must be eliminated from the Debtors Ledger and creditor's Ledger of the purchasing company. Such set off entries may be passed after passing the usual acquisition entries. At the time of preparing the Realization account and passing the business purchase entries no attention need be paid that the two companies involved owe money mutually.

NOTES

Illustration: 8

A Ltd takes over B Ltd for Rs.8, 00,000 payable in Equity share of Rs.10

Fixed Assets Rs.6,00,000 Sundry Debtors Rs.2,00,000 Stock Rs.1,00,000 Bank and Cash Balance Rs.1,00,000 and Sundry Creditors Rs.2,000,000 are taken over. Debtors of B Ltd., include Rs.30, 000 due from A Ltd.

Solution: In the Books of A Ltd Journal Entries

Date			Dr.	Cr.
	Business Purchases A/c Dr. To Liquidation of B Ltd (being the purchase consideration due as per agreement dated)		8,00,000	8,00,000
	Fixed Assets A/c Dr. Sundry Debtors A/c Dr. Stock A/c Dr. Bank and Cash A/c Dr. To sundry creditors A/c To Business Purchase A/c (being the assets and liabilities of B Ltd. brought into account)		6,00,000 2,00,000 1,00,000 1,00,000	2,00,000 8,00,000
	Liquidator of B Ltd A/c Dr. To Equity share capital A/c (being the purchase consideration duly discharged by the issue of 80,000 shares of Rs.10 each)		8,00,000	8,00,000
	Sundry Creditors A/c Dr. To sundry Debtors A/c (being the set off of duces to B Ltd in Debtors account on taking over B Ltd)		30,000	30,000

Illustration: 9

The share capital of the following jute Mills is as follows: Calcutta jute Mills Ltd., 1, 00,000 shares of Rs.100 (Rs.20 paid) Bharakapur Jute Co Ltd, 10,000 shares Rs.80 (Rs.60 paid)

Howrah Jute Mills Ltd., 10,000 shares Rs.20 (fully paid)

The first named company acquires the others on the following terms

a) two of its shares (market value Rs.25) for one share of the Bharakpur jute co. plus Rs.20,000 in cash.
b) 2,40,000 in cash for the business of the Howrah Mills comprising the following assets only.

		Rs.
Building	-	1, 13,400
Plant & Machinery	-	46,300
Book Debts (25 per cent bad)	-	35,920

c) That debts duty to be Bharakpur co. and Howrah mills of Rs.12, 000 and Rs.4, 000 respectively are considered extinguished without payment.
Show complete journal in the purchases company's book calculating the cost of the Bharakpur Co's business on the basis of the market value of the Calcutta jute Mills.

Hints: **Adjustment of the value of the stock**

Intercompany owing may arise due to the purchase and sale of goods among them during or just before the acquisition of business. It is transform likely that the debtor company may be having some unsold stock which was purchased from the other

NOTES

company. In such a case of stock also includes certain element of profit which should be eliminated when two companies amalgamate together.

There are two possibilities under this case:

(1) When the vendor company has purchased goods from the purchasing company and some of which remains unsold during the time of merger.

(2) When the purchasing company has purchase some good from the vendor company and some of which remains unsold. In this face the excess value (the value over the above the cost price) should be treated as a goodwill and the stock will, appear on the original cost value so the adjusting entry will be.

Goodwill A/c Dr.

To stock Account

(The stock value has been reduced to the extent of profit and the same has been debited to goodwill A/c)

Solution:

* For every one share of Bharakpur Co., Ltd., two shares of Calcutta Jute Mills was issued. So total value of shares =

Rs. 10000 x 2 x 25	=	500000
Cash paid		20000

Total Purchase Consideration Rs. 25 being the market value of the shares = 520000

NOTES

In the Book of Calcutta Jute Mills Ltd

	PARTICULARS	Dr.	Cr.
		Rs.	Rs.
	Business Purchase A/c Dr. To liquidator of Bharakpur co. Ltd. (being the purchase – consideration of the assets taken over)	5,20,000	 5,20,000
	Bharakpur jute Co. Ltd A/c Dr. To business Purchases A/c the mills liability personal account transferred to the later A/c)	12,000	 12,000
	Bharakpur jute co Ltd. Dr. fo Share Capital A/c To share Premium A/c (being the issue of 20,000 shares of Rs.100 each 20 paid up to vendors in part payment of purchase price at a premium of Rs.5 per share)	5,00,000	 4,00,000 1,00,000
	Liquidator of bharakpur Jute Co., A/c Dr. To Bank A/c (being cash payment)	20,000	 20,000
	Business Purchase A/c Dr.	2,40,000	

NOTES

	To Liquidator of Howrah Jute Mill Ltd A/c (being the value of assets taken)		2,40,000
	Howrah Jute Mill Ltd A/c Dr. To Business Purchase A/c (being the transfer of Mills liability)	4000	 4000
	Building A/c Dr Plant & Machinery A/c Dr Book Debts A/c Dr Goodwill A/c Dr To Business Purchase A/c (being the amount of various assets purchased from vendors)	1,13,400 46,300 26,940 49,360	 2,36,000
	Liquidator of Howrah Jute Mill Ltd A/c Dr To Bank A/c (being cash paid in full satisfaction of purchase consideration)	2,40,000	 2,40,000

Illustration : 10

NOTES

Madras Traders Ltd., Having proved unsuccessful resolved by a special resolution to wind for the purpose of reconstruction and sale to a new company called Tamilnadu Traders ltd., The balance sheet of the Madras Trade Ltd., On 31st March 2009 was as follows :

Dr. Cr.

10000 equity shares of Rs.		Land & buildings	400000
10/- each	100000	Land &buildings	400000
Sundry Creditors	40000		
Bills Payable	20000	Plant & Machinery	300000
		Debtors	90000
		Stock	50000
		Cash at Bank	20000
		Profit & Loss A/c (Accumulated loss)	200000
	1060000		1060000

The scheme of reconstruction agreed by all parties was as follows:

a) Capital of the Tamilnadu Trader limited should be Rs. 15,00,000 comprising in 150000 shares of Rs. 10 each

b) The Taminadu Traders Limited would take Land & Buildings, Plant & Machinery, Debtors and stock for Rs. 750000 payable by 140000 shares of Rs.10 each with Rs. 5 per share credited as paid up and Rs. 50 and Rs. 50000 each.

NOTES

c) The shareholders of the Tamilnadu Traders Limited should pay the balance of Rs. 5 per share due on the shares allotted to them. The entire amount was paid in full.

d) The expense of reconstruction amounted to Rs. 10000 and was borne by Madras Tranders Limited. Pass Journal Entries to close the books of Madras Trader Ltd., and show the opening balance sheet of Tamilnadu Traders limited.

Balance Sheet of Tamil Nadu Traders Ltd as at 1st April 2009

Liabilities	Rs.	Asset	Rs.
Share Capital :		Fixed Assets	
Authorized 1,50,000 share of Rs.10 each	15,00,000	Land & Building	4,00,000
Issued & Subscribed		Plant & Machinery	
1,40,000 shares of Rs.10 each full paid shares issued to vendor for business purchased as Rs.10 paid up and		Current Assets Loans and Advances	
		Stock	50,000
		Debtors	90,000
		Bank **	6,50,000
Rs.5 called up	14,90,000		
Reserve & Surplus			
Capital Reserve			
	14,90,000		14,90,000

Journal of Madras Traders Ltd.,

NOTES

2009			Dr.	Cr.
Mar 31	Realization A/c To Land & buildings A/c To plant & Machinery A/c To Debtors A/c To Stock A/c (being the various assets transferred to Realization A/c)		8,40,000	 4,00,000 3,00,000 90,000 50,000
	Tamilnadu trader's ltd. A/c To Realization A/c (being the amount to be paid by Tamilnadu traders ltd., for the assets taken over as per agreement		7,50,000	 7,50,000
	Bank A/c Dr. Shares in T.N Traders A/c To Tamilnadu Traders A/c (being the receipt of each and party paid shares of 140000 at Rs. 5 in satisfaction of the price for the business)		50,000 7,00,000	 7,50,000
	Realisation A/c Dr. To Bank A/c (being the reconstruction Expenses paid)		10,000	 10,000
	Sundry Creditors A/c Dr. Bills Payable A/c To Bank A/c (being the liabilities paid off)		40,000 20,000	 60,000
	Equity share capital A/c Dr. To Equity share holders A/c (being the transfer of capital account to share holders A/c)		10,00,000	 10,00,000
	Equity share capital A/c Dr. To Profit and Loss A/c (being the transfer of accumulated losses to the share holders A/c)		2,00,000	 2,00,000
	Equity shareholders A/c Dr. To Realisation A/c To Realisation A/c (being the loss on realization transferred to former A/c)		1,00,000	 1,00,000 1,00,000
	Equity shareholders A/c Dr. To share in Tamil Nadu Traders Ltd A/c (being the partly paid shares distributed)		7,00,000	 7,00,000

NOTES

Illustration: 11 **(External Reconstruction)**

On September 30, 2009 the Balance Sheet of Bright Ltd was as follows:

Liabilities	Rs.	Asset	Rs.
Authorized 10,000 equity shares of Rs. 100 each	1,00,000	Sundry Assets	2,60,000
1,000 6% cumulative preference Shares of Rs.100 each	1,00,000	Cash	1,000
Issued subscribed & paid up		Profit & Loss (Deficit)	80,000
6,000 Equity shares of Rs.10	60,000		
600 6% Cumulative Preference Shares of Rs.100 fully paid	60,000		
5% Debentures	30,000		
Trader Creditors	30,000		
Bank o/d (Against some of Sundry Assets)	60,000		
	3,41,000		3,41,000

Capital Reserve in arrived at like this to all value of the asset taken over	-	8,40,000
But Rs.7,00,000 shares plus cash Rs.50,000 paid for the same	-	7,50,000
		90,000
** Rs.5 / Per share on 1,40,000 shares received on allotment of shares	-	7,00,000
Cash paid to Madras Traders Ltd	-	50,000
		6,50,000

NOTES

1. It was decided to reconstruct the company and for this purpose. Bright Future Ltd was registered with a capital of Rs.2,00,000 divided into 8,000 Equity shares of RS.10 each and 1,200 (Seven Percent) Preference shares of Rs.100 each to take over the assets and liabilities of the Bright Ltd.

2. The Debentures holders of Bright Ltd Agreed to accept 7% preference shares in the new company in exchange for their debentures.

3. The Preference shareholders were to received one Preference Share in Bright future ltd for every 3 such held by them in the old company.

4. The equity shareholders were to be allotted one Equity share Rs.8 paid in the new company for every 4 such held by them in the old company.

5. Bright Future Ltd issued 3,500 Equity share sof RS.10 each at per and called up the balance of Rs.2 on the Equity Shares issued to the shareholder sin Bright Ltd

6. The costs of liquidation Rs.760 of Bright Ltd were paid by the new company.

7. The Preliminary Expenses of Bright Future Ltd which have been paid were Rs.240. You are requested to

NOTES

(A) Give the Journal Entries in the books of the old and new companies

(B) Show the balance Sheet of Bright Future Ltd

Solution: **Journal of Bright Ltd**

Date	PARTICULARS	L.F	Dr.	Cr
2009 Sep 30	Realization A/c Dr To Sundry Assets A/c To Cash A/c (being the various assets transferred to Realization A/c)		2,61,000	 2,60,000 1,000
	5% Debentures A/c Dr Trade Creditors A/c Dr. Bank Old A/c Dr. To Realisation A/c (being the liability transferred to the later A/c)		30,000 30,000 61,000	 1,21,000
	Bright Future Ltd A/c Dr To Realisation A/c (being the amount to the paid by Bright Future Ltd for the business taken over as per agreement)		32,000	 32,000
	6% Preference Shares in Bright Future Ltd A/c Dr Equity Shares in Bright Future A/c Dr. To Bright Future Ltd A/c (being the receipt 200 preference shares of Rs.100 each and 1,500 Equity Sharse of Rs. 8/-)		20,000 12,000	 32,000
	Equity Share Capital A/c Dr 6% Cumulative Pref. Share Capital A/c Dr. To Equity Shareholders A/c To Cumulative Shareholders A/c (being the transfer of Capital accounts to respective holders A/c)		60,000 60,00	60,000 60,000
	Equity Shareholders A/c Dr To Profit & Loss A/c (being the various deficit transferred to the former A/c)		80,000	 80,000
	6% Cumulative Preference shareholders A/c Dr To Realisation A/c (being the loss to preference shareholders on account of conversion i.e Rs.60,000 worht of are exchanged for Rs.20,000)		40,000	 40,000
	Realisation A/c Dr To Equity Shareholders A/c (being the profit on realization transferred to the latter A/c)		32,000	 32,000
	Equity Shareholders A/c Dr 6% Cumulative Preference Shareholders A/c Dr. To Equity Shares in Bright Future Ltd A/c To 75 Preference share in Bright Future Ltd A/c		12,000 20,000	 12,000 20,000

Journal of Bright Future Ltd

NOTES

Date	PARTICULARS	L.F	Dr.	Cr
2009	Business Purchase A/c Dr To Liquidator of Bright Ltd A/c (being the amount due to the liquidator as per agreement dated for the business taken over by)		32,000	32,000
	Sundry Assets A/c Dr Cash A/c Dr To 5% Debentures A/c To Trade Creditors A/c To Business Purchase A/c To Bank O/d A/c To Capital Reserve A/c (being the assets and liabilities of Bright Ltd brought into account and difference credited to Capital Reserve i.e Rs. 2,61,000 minus 2,53,000)		2,60,000 1,000	30,000 30,000 1,61,000 32,000 8,000
	Liquidator of Bright Ltd A/c Dr To Party paid Equity Share Capital A/c To 7% Preference Share Capital A/c (being the issue of 1,00 Equity share at Rs.8 and Rs.200 preference at Rs.100 in full satisfaction for the takeover of the business of Bright ltd)		32,000	12,000 20,000
	5% Debentures A/c Dr To 7% Preference Share Capital A/c (being the issue of 75,300 preference shares in exchange)		30,000	30,000
	Bank A/c Dr To Equity Shires Capital A/c (being the issue of 3,500 shares at Rs.10/- for cash)		35,000	35,000
	Goodwill A/c Dr To Bank A/c (being the liquidation / expenses Bright Ltd Paid being debited to Goodwill)		760	760
	Preliminary Expenses A/c Dr To Bank A/c (being the preliminary expenses paid)		240	240

NOTES

Balance Sheet of Bright Future Ltd As at 1st October 2009

Liabilities	Rs	Asset	Rs
SHARE CAPITAL		FIXED ASSETS	
Authorized 8,000 Equity share of		Goodwill	7660
Rs. 10 each	80,000	Sundry Assets	2,60,000
1,200, 75 Preference Shares of Rs. 100 each	12,00,000		
	12,80,000		
		CURRENT ASSETS LOANS& ADVANCES	
ISSUED SUBSCRIBED & PAID UP		Cash Balance	1,000
5,000 Equity Share of Rs. 10 Each	50,000	Bank Balance	37,000
500, 75 Preference shares or Rs. 100 each	50,000	MISCELLANEOUS EXPENDITURE	
RESERVES & SURPLUS :		Preliminary expenses	240
Capital Reserve	8,000		
SECURED LOANS Bank	1,61,000		
CURRENT LIABILITIES AND PROVISION			
Creditors	30,000		
	2.99.000		
	2.99,000		2.99,000

* Issued of 3,500 shares at Rs.10 per share for Rs.35,000 plus call money on 1,500 shares at Rs.2 per share for Rs.3,000 Liquidation Expenses of Rs.240 and a balance of Rs.37,000 at bank.

Illustration : 12

NOTES

On 1st January 2009 A Ltd and B Ltd agree to amalgamate by transferring their undertakings to a new company AB Ltd formed for that purpose with a capital of Rs.10 lakhs divided into shares of Rs.10 each. On 1st January 2010 the Balance Sheets of the companies stood as under.

Liabilities	A Ltd Rs	B Ltd Rs	Assets	A Ltd Rs	B Ltd Rs
Shares of Rs.4 each	5,00,000	3,00,000	Land & Building	2,00,000	1,00,000
10 Debentures	-	1,00,000	Plant & Machinery	3,20,000	2,30,000
Mortgage loan	60,000	-	Stock	80,000	60,000
General Reserve	50,000	-	Sundry Debtors	65,000	50,000
Profit & Loss A/c	45,000	20,000	Cash at bank	15,000	-
Sundry Creditors	45,000	30,000	Preliminary exp.	20,000	10,000
	7,00,000	4,50,000		7,00,000	4,50,000

AB Ltd agreed to take over the trade liabilities and assets (except cash of A Ltd) of both companies, the consideration being

i) Discharge of the debentures of B Ltd by the issue of an equivalent amount of 12% debentures of AB Ltd

NOTES

ii) A cash payment of 50 paise per share of A Ltd and B Ltd

iii) Exchange of one share of Rs.10 each at the agreed value of Rs.14 per share of AB Ltd for every two shares held in A Ltd & B Ltd.

iv) AB Ltd issued 10,000 shares to its directors at Rs.14 per share and the amount received immediately. For the purpose of amalgamation assets of both the companies were revalued as given below.

	A Ltd (Rs)	B Ltd (Rs)
Goodwill	1,00,000	1,75,000
Land & Building	2,50,000	1,20,000
Plant & Machinery	3,10,000	1,80,000
Stock	72,000	56,000
Sundry Debtors	63,000	49,000

Close the books of both A Ltd and B Ltd. Give opening journal entries in the books of AB Ltd and prepare the Balance Sheet of AB Ltd as it will appear immediately after amalgamation.

Solution: Calculation of Purchase Consideration A Ltd

	Rs.
i) Cash payment @ 50 paise (1,00,000 x 0.50)	50,000
ii) One share of Rs.10 each at the agreed value of Rs.14 of AB Ltd for every two shares (1,00,000/2 x 14)	7,00,000
Purchase Consideration	**7,50,000**

B Ltd Rs.

NOTES

i) Debenture holders :

12% Debentures instead of 10% debentures 1,00,000

ii) Shareholders 7,00,000

a) Cash payment @ 50 paise per share (60,000 x 0.50) 30,000

b) One share of Rs. 10 each at the agreed value of Rs.14 4,20,000

of AB Ltd for every two shares (60,000/2 x 14)

Purchase Consideration **5,50,000**

Ledger Accounts in the Books of A Ltd

Realization A/c

	Rs.		Rs.
To Land & Building	2,00,000	By Sundry Creditors	45,000
To Plant & Machinery	3,20,000	By AB Ltd	7,50,000
To Stock	80,000		
To Debtors	65,000		
To Eq. Shareholders (B/F)	1,30,000		
	7,95,000		7,95,000

NOTES

Mortgage Loan A/c

	Rs.		Rs.
To Bank	60,000	By Balance c/d	60,000
	60,000		60,000

AB Ltd A/c

	Rs.		Rs.
To Realisation	7,50,000	By Bank	50,000
		By Shares in AB Ltd	7,00,000
	7,50,000		7,50,000

Shareholders A/c

	Rs.		Rs.
To Preliminary expenses	20,000	By Share Capital	5,00,000
To Shares in AB Ltd	7,00,000	By General Reserve	50,000
To Bank	5,000	By P & L A/c	45,000
		By Realisation	1,30,000
	7,25,000		7,25,000

Bank A/c

	Rs.		Rs.
To Balance b/d	15,000	By Mortgage Loan	60,000
To AB Ltd	50,000	By Shareholders	5,000
	65,000		65,000

Ledger Accounts in the Books of B Ltd

Realization A/c

	Rs.		Rs.
To Land & Building	1,00,000	By Sundry Creditors	30,000
To Plant & Machinery	2,30,000	By AB Ltd	5,50,000
To Stock	60,000		
To Debtors	50,000		
To Eq. Shareholders (B/F)	1,40,000		
	5,80,000		5,80,000

NOTES

NOTES

Bank A/c

	Rs.		Rs.
To AB Ltd	30,000	By Shareholders	30,000
	30,000		30,000

AB Ltd A/c

	Rs.		Rs.
To Realisation	2,00,000	By 9% Deb. in AB Ltd	1,00,000
		By Shares in AB Ltd	4,20,000
		By Bank	30,000
	5,50,000		5,50,000

Shareholders A/c

	Rs.		Rs.
To Preliminary Expenses	10,000	By Share Capital	3,00,000
To Shares in AB Ltd	4,20,000	By P & L A/c	20,000
To Bank	30,000	By Realisation	1,40,000
	4,60,000		4,60,000

In the Books of AB Ltd: Journal Entries of AB Ltd

		L.F	Dr.	Cr
1)	Business Purchase A/c Dr To Liquidator of A Ltd A/c To Liquidator of B Ltd A/c (being purchase of business)		13,00,000	 7,50,000 5,50,000
2)	Land & Building A/c Dr Plant & Machinery A/c Dr Stock A/c Dr Sundry Debtors A/c Dr Goodwill A/c Dr To Sundry Creditors A/c To Business purchase A/c (being assets and liabilities taken over)		2,50,000 3,10,000 72,000 63,000 1,00,000	 45,000 7,50,000
3)	Liquidator of A Ltd A/c Dr To Share Capital A/c To Share Premium A/c To Bank A/c (being purchase consideration paid)		7,50,000	 5,00,000 2,00,000 50,000
4)	Land & Building A/c Dr Plant & Machinery A/c Dr Stock A/c Dr Sundry Debtors A/c Dr Goodwill A/c Dr To Sundry Creditors A/c To Business purchase A/c (being assets and liabilities taken over)		1,20,000 1,80,000 56,000 49,000 1,75,000	 30,000 5,50,000
5)	Liquidator of B Ltd A/c Dr To Share Capital A/c To Share Premium A/c To 9% Debentures A/c To Bank A/c (being purchase consideration paid)		5,50,000	 3,00,000 1,20,000 1,00,000 30,000
6)	Bank A/c Dr To Equity Share Capital A/c To Share Premium A/c (being share issued to directors)		1,40,000	 1,00,000 40,000

NOTES

Balance Sheet of AB Ltd as on 31.12.2009

Liabilities	Rs.	Asset	Rs.
Authorised Capital		Goodwill	2,75,000
1,00,000 Eq. shares of	10,00,000	Land & Building	3,70,000
Rs. 10 each		Plant & Machinery	4,90,000
Issued & Paid up		Stock	1,28,000
90,000 Eq. Shares of	9,00,000	Sundry Debtors	1,12,000
Rs. 10 each		Bank	60,000
Share Premium	3,60,000		
12% Debentures	1,00,000		
Sundry Creditors	75,000		
	14,35,000		14,35,000

NOTES

Exercise

1. The following in the Balance Sheet of A Co. Ltd as 31st December 2009.

	Rs.		Rs.
Authorized & issued			
1,000 Equity shares of Rs.100		Fixed Assets	70,000
each fully paid up		Floating Assets	41,000
5,000 Equity Shares	1,00,000		
8% Debentures	20,000	Profit & Loss A/c	
Sundry Creditors	3,000	(Debit)	12,000
	1,23,000		1,23,000

It was decided to reconstruct the company and for this purpose a new company was formed (A Co. Ltd 91994) with an Authorized Capital of RS.1,00,000 divided into 500 (ten percent) preference of Rs.100 each and 50 Equity shares of Rs.100 each to take over the assets and liabilities of the A Co. Ltd on the following basis. a) That Debentures holders in the A Co. Ltd are to accept 200 Preference shares b) That Equity shareholders of the A Co. Ltd are to receive one Equity share in new company for every two share held by them in the old company. That the cost of liquidation Rs.1, 500 paid by the new company. Assuming that the balance of the Preference shares is issued payable in cash are required. a) to close the books of old company and b) to give the initial balance sheet of the new company (Hints : Purchase Price Rs.50,000 Realization Loss Rs.8,000 Equity shares Received Rs.50,000 New company cash Rs.29,500 Goodwill RS.1,500, Capital Reserve Rs.38,000 ; Balance sheet total Rs.1,41,000)

NOTES

2. Distinguish between a) Amalgamation and Absorption b) External Reconstruction and internal Reconstruction

3. What is purchase consideration Explain the various methods of its calculation?

4. The following are the Balance Sheet of A.Co Ltd, and B.Co Limited

A. Company Ltd

	Rs.		Rs.
CAPITAL			
5,000 Equity Shares of Rs.10		Building	15,000
each	50,00		
100 (6%) Debentures of Rs.100		Machinery	55,000
each	10,000		
Reserve Fund	17,000	Stock	8,000
Dividend Equalization Fund	2,000	Debtors	7,000
Profit & Loss A/c	1,000	Cash	1,500
Creditors	5,000		
Employee's Provident Fund	1,500		
	86,500		86,500

B Company Ltd

	Rs.		Rs.
CAPITAL			
15,000 Equity Shares of Rs. 20 each	30,000	Machinery	25,000
Creditors	4000	Stock	4,000
		Debtors 5,000	
		Less : Reserve 500	4,500
		Cash	500
	34,000		34,000

The two companies agree to amalgamate and forma new company called "C Company Limited" which taken over the assets and liabilities of both companies. The assets of A Company Limited are taken over at reduced valuation of 10% with the exception of Building which is accepted at book value. Both companies are to received 5% of the net valuation of their respective business as good will the entries purchase price is to be paid by C company Ltd in fully paid Equity share of Rs.1/0 each in return for Debentures of A Company Ltd Debentures of the same amount and denomination are to be issued by C Company Ltd. Give journal Entries to close the books of A Company Ltd And show the opening balance sheet of C Company Ltd is Rs.1,00,000 in Rs.1/- Equity Shares. (Hints : Creditors & Employee's PF are liabilities : Purchase consideration - A Rs. 76,650 and B Rs.31,500 goodwill Rs.5150 (3650 + 1500) Balance Sheet Total Rs.1,18,650)

NOTES

5. The Store Ltd Entries in to an agreement to acquire the assets and liabilities of Local bazaars ltd The agreement provided Among others that (i) The shareholders of Local Bazaars Ltd Were to receive in exchanges for every 5 preference shares held (four) 65 Preference shares of Rs.1/- each fully paid in the Stores ltd And (ii) For every 2 Equity shares held 3 Equity of Shares Rs.1/- each full paid in the store ltd. The Balance Sheet of Local Bazaars Ltd At the date of transfer was a follows

	Rs.		Rs.
Authorised & issued Share			
Capital 1,500 (5%) Preference		Goodwill	3,000
Shares	1,500	Land & Buildings	2,500
5,000 Equity Shares	5,000	Fixtures 7 Fittings	1,500
Trade Creditors	2,200	Stock in Trade	4,000
General Reserve	2,000	Bank & Cash Balance	300
Profit & Loss A/c	1,500	Sundry Debtors	900
	12,200		12,200

Prepare journal Entries for closing the books of Local Bazaars Ltd and for recording the purchase in the book of the stores ltd (hints : Purchase consideration Rs.8,700 Difference being debited to GOODWILL Rs.1,700 in the Stores Ltd)

NOTES

LESSON-11

INTERNAL RECONSTRUCTION

11. 1 INTRODUCTION

Normally these are two types of altering the share capital of a company (i) Alterations which do not require the approval of a court of law. (ii) Altering which require prior approval of a court of law (Internal reconstruction).

Reconstruction literally means rebuilding something in a different form. Similarly reconstruction of a company implies rebuilding a company which is not good shape now. it may take either of the two forms viz (i) internal and (ii) external. Under external reconstruction the company which is under reconstruction goes into liquidation and a new company is formed in its place. The new company is generally formed with the same of similar name. With the same objects and is composed of the same shareholders as the old company which is liquidated. On the other hand internal Reconstruction generally stands capital reduction. There is no liquidation of the company nor does any company new or old buy the business of the company which is going for an internal reconstruction. Internal reconstruction is carried out by keeping in view legal provision.

NOTES

A company can reduce its capital provided if it is authorized by its Articles of Association by passing a special Resolution and obtaining the confirmation of the count normally. The court will consult the creditors affected. The court will make an order confirming the reduction of capital on such terms and conditions as it thinks fit. The court may direct the compa: y to add the words "And Reduced" to it name for such period as it thinks fit. After the scheme has been sanctioned by the court all members are bound by the order. A copy of the order must be filed with the Register. Actual reduction of capital can be brought in any of the following was: 1. Canceling and paid up share capital 2. Paying off share capital which is in excess of needs of company.

11.2 ACCOUNTING TREATMENT

I. The capital so reduced is credited to an account known as Capital Reduction A/c in the first instance. (The corresponding debit goes to Share Capital A/c) II. Then the capital reduction A/c is debited and the various losses and over - valuation of other assets that are to be written off are credited. III. After making these adjustments the redrafted Balance sheet will show the position of the assets and liabilities at realizable and dischargeable values. In this way scheme will be given effect to and secured position will be restored.

Internal Reconstruction Scheme

NOTES

When a company has accumulated losses or when a company finds it over capitalized or difficult to pay dividend a scheme of capital reduction will be drawn up. Firstly a careful estimate of the profits expected by the company in the future should be made. Otherwise the need for another reconstruction will arise again. Secondly the scheme should not adversely affect the interest of creditor's debentures holders and preference shareholders. Of course the preference shareholders may be persuaded to accept a sacrifice either by reduction of capital to forego the arrears of dividend by they should be offered some consideration for so doing in the form of higher rate as will yield the same income. In extreme cases creditors also may have to make a sacrifice. Thirdly the equity shareholders have to sacrifice a lot bear major portion of the losses. They are fully aware that if losses occur. They have to bear; before anybody else can be called up on to do so. This is due to the fact that they enjoy control over the affairs of the company. Fourthly the requirements of the working capital must be taken into account for which new shares be issued. Cash may be required to pad arrears of preference dividend etc Money will be required for current expenses. Finally (i) Ascertain the total amount that should be written off (ii) Determine the sacrifice to be made by Preference and Equity shareholders and creditors.

(iii) As far as possible the dividend income on preference share must remain unchanged (for this we can increase the rate of dividend on it. Say from 6% to 7% but the total dividend income will be the same)

NOTES

Illustration: 1

The Balance Sheet of Seven star Limited shows the following position as at 31st December 2009.

	Rs.		Rs.
Share capital :		Freehold Premises	50,000
Authorized 30,000 Equity shares		Plant and Machinery	1,00,000
of Rs. 10/- each	3,00,000		
Issued and subscribed 20,000		Stock	28,000
Equity shares of			
Rs.10 fully paid	2,00,000		
Sundry Creditors	22,500	Sundry Debtors	16,000
Bank overdraft	37,500	Cash at Bank	500
		Preliminary expenses	3,000
		Profit & Loss Account	62,500
		(Debit Balance	
	2,60,000		2,60,000

NOTES

A Capital Reduction is brought about for this company by passing the following resolutions:

1. That the shares be reduced to the same number of shares of Rs.5/- full paid

2. The sum thus made available is utilized:

   a) in writing off the debit balance of profit and loss account

   b) in writing off the preliminary expenses account

   c) in writing down the Machinery Account by Rs.30,000 (to bring it to the present market value)

   d) in writing down stock by Rs.2,500 (current market rates)

   e) in providing at Reserve of Rs. 2,000 for Doubtful Debts (to bring down the debtors to realizable value) Shew the Journal Entries and redraft the Balance Sheet.

NOTES

Solution:

Journal of Bright Future Ltd

Date		L.F	Dr.	Cr
2009 Dec 31	Equity shares capital (Rs. 10 shares) A/c Dr To Equity Capital (Rs. 5 share A/c) To Equity Reduction A/c (being the reduction of Rs.5 per shares on 20,000 Equity share made as per Special Resolution dated and confirmed be the court)		2,00,000	 1,00,000 1,00,000
	Capital Reduction A/cDr To Profit & Loss A/c To Preliminary Expenses A/c To Plant & Machinery A/c To Stock A/c To Bad Debts Reserve A/c (being the amount capital reduction used to write to off the various assets as indicated in the special Resolution)		1,00,000	 82,500 3,000 30,000 2,500 2,000

Balance Sheet of Bubble Co. Ltd As at 1st January 2009

	Rs.		Rs.
Share capital :		Fixed Assets	
Authorised 30,000 Equity		Freehold Premises	50,000
Share of Rs. 5 each	1,50,000		
Issued & Subscribed 20,000			
Equity share of RS. 5 each			
fully paid	1,00,000	Plant & Machinery 1,00,000	
		Less : Written of under	
Bank O/d	37,500	Reconstruction scheme 30,000	70,000
		Current assets Loans &	
Current Liability &		Advances	
provisions		Stock 28,000	
Sundry Creditors	22,500	Less : Written off under	
		Reconstruction scheme 2,500	25,500
		Sundry Debtors 16,000	
		Less : Bad Debtors	
		Provisions 2,000	14,000
		Cash at Bank	500
	1,60,000		1,60,000

NOTES

3. The Balance Sheet of Jagan Company limited as at December 31,2009 stood as follows:

Liabilities	Rs.	Assets	Rs.
Authorized and issued		Goodwill	42,000
capital 6,000 pref.		Premises	72,000
shares of Rs.10 each		Plant	52,000
fully paid	60,000	Loose Tools etc.,	15,000
18,000 Equity shares of		Stock	12,500
Rs.5 each fully paid	90,000	Debtors	18,000
6% debentures	36,000	Bills receivable	6,000
Creditors	60,000	Cash	1,500
		Profit and Loss account	27,000
	2,46,000		2,46,000

On revaluation of the assets, it was found that the Goodwill was worthless and that the assets were overvalued to the following extent:

	Rs.
Premises	15,000
Plant	7,500
Tools etc.	9,000
Debtors	1,500

A scheme of arrangement and reduction of capital was agreed to by the court and the creditors on the following lines:

(a) That the creditors should accept 6% debentures to the extent of half their debts, the balance being payable in cash.

(b) That the preference shares should be reduced to shares of Rs.5 each fully paid.

(c) That the equity shares should be reduced to shares of Rs.1 each.

(d) That the assets should be reduced to the re-valued figures.

Draft the journal entries for affecting the above scheme, and prepare a Balance sheet on completion.

Journal Entries

(1)	Creditors A/c Dr. To 6% Debenture A/c (Being the Creditors are accept 50% of their debts as 6% Debenture [60,000 X 50/100]	30,000	 30,000
(2)	Pref Share Capital (Rs.1-0/- each) Dr. To Preference Share Capital (Rs.5/- each) To Capital Reduction a/c (Being the preference shares are reduced to Rs.5/-)	60,000	 30,000 30,000
(3)	Equity Share Capital (Rs.5/-) Dr. To Equity Share Capital (Rs.1/-each) To Capital Reduction (Being the Equity Shares are reduced to Rs.1/-	90,000	 18,000 72,000
(4)	Capital reduction a/c Dr. To Profit & loss A/c To Goodwill a/c To Premises a/c To Plant a/c To Tools a/c To Debtors a/c (Being the assets are written off for reconstruction by using Capital reduction a/c.	1,02,000	 27,000 42,000 15,000 7,500 9,000 1,500

<u>Note:</u> During reconstruction, P & L a/c [Loss] should be written off first.

NOTES

Balance Sheet (after reconstruction)

Authorized and Issued Capital		Goodwill	42,000	
		(-): written off		
6,000 Preference Shares @ Rs.5/- each	3,000	Premises	42,000	Nil
		(-): written off	72,000	
18,000 Equity Shares @ Rs.1/- each	18,000		15,000	57,000
6% Debenture [36,000+30,000]	66,000	Plant	52,000	
		(-): written off	7,500	
Creditors Payable (50%)	30,000			44,500
		Loose Tools	15,000	
		(-): written off	9,000	
				6,000
		Stock		12,500
		Debtors	18,000	
		(-): written off	1,500	16,500
		B/R		6,000
		Cash		1,500
		P & L a/c	27,000	
		(-): written off	27,000	Nil
	1,44,000			1,44,000

NOTES

3. **The Balance Sheet of X Ltd., is as follows:**

	Rs.		Rs.
10,000 equity shares		Goodwill	10,000
of Rs.10 each	1,00,000	Fixed Assets	90,000
10,000, 7% pref.		Stock	25,000
shares of Rs.10 each	1,00,000	Debtors.	30,000
		Profit/Loss a/c	45,000
	2,00,000		2,00,000

It was resolved that equity shares of Rs.10 each, be reduced to fully paid shares of Rs.6 each and 7% preference shares of Rs.10 each, be reduced to 8% preference shares of Rs.7 each. Number of shares in each case remained the same. The amount so available will be used to write off P/L a/c, goodwill and the balance of any on Fixed Assets. You are required to make journal entries and prepare revised Balance Sheet.

NOTES

Journal Entries

1.	Equity Shares Capital a/c (Rs.10) Dr. To Equity Share Capital a/c (Rs.6) To Capital Reduction a/c (Rs.5) (Being capital reduced for reconstruction	1,00,000	 60,000 40,000
2.	7% Pref Shares Capital a/c (Rs.10) Dr, To 8% Pref Shares Capital a/c (Rs.7) To Capital Reduction a/c (Rs.3) (Being capital reduced for reconstruction)	1,00,000	 70,000 30,000
3	Capital Reduction a/c Dr. (40,000 + 30,000) To Profit and Loss a/c To Goodwill a/c To Fixed Assets a/c (Being the Assets written off)	70,000	 45,000 10,000 15,000

NOTES

Revised Balance Sheet

Liabilities		Assets		
10,000 Equity Shares of Rs.6/- each	60,000	Fixed Assets	90,000	
		(-) Written off	15,000	
			------------------	75,000
8% Preference Shares of Rs.7/- each	70,000	Stock in Trade		25,000
		Debtors		30,000
		Goodwill	10,000	
		(-) Written off	10,000	
			------------------	Nil
		Profit & Loss a/c	45,000	
		(-) written off	45,000	
			------------------	Nil
	1,30,000			1,30,000

NOTES

4. The working of Balan and Company Limited was not successful. On 31.12.2009, the company balance sheet was as under:

Liabilities	Rs.	Assets	Rs.
Nominal capital		Land and Buildings	1,00,000
20,000 share of Rs. 100 each	20,00,000	Machinery	2,60,000
Subscribed capital:		Furniture	20,000
19,000 shares of		Stock	3,70,000
Rs. 100 each fully paid	19,00,000	Debtors	1,80,000
Creditors	1,00,000	Goodwill	2,00,000
Balan	1,00,000	Profit & Loss A/C.	9,70,000
	21,00,000		21,00,000

The company is to be reconstructed on the basis of the following scheme:

a. The 19,000 shares of Rs. 100 each are to be reduced to an equal number of fully paid shares of Rs. 40 each.
b. The debt of Rs.1, 00,000 due to Balan was also to be adjusted by issuing the remaining 1,000 unissued shares being issued to him as fully paid up shares of Rs. 40 each in full settlement.
c. The amount thus rendered available by the reduction of capital and by the above arrangements with Balan is to be utilized in writing off the goodwill and the profit and loss account and in writing down the value of machinery. Pass entries and draft the new balance sheet.

NOTES

Book of Balan and company Limited: - Journal Entries

Date	Particulars	Rs.	Rs.
31.12.09	Share Capital A/c	11,40,000	
	To Capital Reduction A/c		11,40,000
	(Being reduction of Rs. 60 per share on 19,000 shares)		
	Balan's A/c	1,00,000	
	To Share capital A/c.		40,000
	To Capital Reduction A/c.		60,000
	(Being issue of 1,000 shares of Rs. 40 each to Balan and the balance Credited to capital reduction)		
	Capital reduction A/c. Dr.	12,00,000	
	To Profit & Loss A/c.		9,70,000
	To Goodwill A/c		2,00,000
	To machinery A/c. (balance)		30,000
	(Being losses written off and assets written down as per capital reduction schemes)		

NOTES

Balance sheet of Balan and Co. Ltd., (Reduced) as on 31.12.09

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
Nominal capital			Land and Buildings		1,00,000
20,000 share of	8,00,000				
Rs. 40 each			Machinery	2,60,000	
Issued and			Less: Reduction	30,000	2,30,000
Paid up capital			Furniture		20,000
20,000 shares of			Stock		3,70,000
Rs.40 each		8,00,000	Debtors		1,80,000
Creditors		1,00,000			
		9,00,000			9,00,000

NOTES

11.4 SHOW YOUR PROGRESS

1. What is Internal Reconstruction? Give example?
2. Distinction between Internal Reconstruction & External Reconstruction.
3. Explain fully capital reduction scheme. Illustrate your answer with an Example.
4. The following is the Balance Sheet of Nav Bharath Ltd., Company on 31-12-2009

	Rs.		Rs.
7,500 Preference shares of Rs.100 each	7,50,000	Patents	8,50,000
5,000 equity shares of Rs.100 each fully paid	5,00,000	Leasehold Premises	1,30,800
Sundry Creditors	30,000	Machinery	42,200
Bank Overdraft	20,000	Debtors	76,500
		Stock in Trade	55,000
		Discount on issue of shares	18,000
		Preliminary Expenses	12,000
		Profit & Loss Account	1,15,000
		Cash in Hand	500
	13,00,000		13,00,000

NOTES

The company suffered heavy losses. The following scheme of reconstruction was adopted: (a) the preference shares be reduced to an equal number of fully paid shares of Rs.50 each. : (b) The equity shares be reduced to an equal number of shares of Rs.25 each. The amount available be used to write off Rs.30,800 on leasehold premises, Rs.15,000 on stock, 20% off on machinery and Sundry debtors and the balance available (after writing off discount on issue of shares, preliminary expenses and Profit and Loss Account completely) of patents. Journalize the transactions and prepare the balance sheet after the reconstruction has been carried out.

5. Following was the Balance Sheet of X Ltd. as on 31.03.2009:

Liabilities	Rs.	Assets	Rs.
Equity share capital		Goodwill	50,000
4,000 share of		Land and Building	1,40,000
Rs.100 each	4,00,000	Plant and Machinery	1,50,000
7% Preference		Patent Rights	40,000
Capital 2,000		Stock	1,60,000
share of Rs.100 each	2,00,000	Debtors	2,15,000
6% Debentures	2,00,000	Cash in Hand	5,000
Sundry Creditors	2,00,000	Prel., expenses	25,000
		Discount on issue of Debentures	15,000
		Profit/Loss a/c	2,00,000
	10,00,000		10,00,000

The following scheme of Reconstruction was duly accepted:

a. Equity Shares are to be reduced to equal number of fully paid shares of Rs.50 each.
b. 7% Preference shares are to be reduced by 30% and the rate of dividend increased to 9%.
c. The value of Land Buildings is to be increased by 10%.
d. The Debentures are to be reduced by 20%.
e. All nominal and fictitious assets are to be eliminated and Balance used to write off patents.
f. Further equity shares are to be issued for Rs.50,000 for cash.

Assuming that the scheme is fully carried out, pass journal entries and prepare Balance Sheet.

Ans: Balance Sheet total Rs.7, 50,000

Capital Reduction A/c:Rs.3, 14,000.

NOTES

What is Liquidation?

Termination of a business operation by using its assets to discharge its liabilities

LESSON -12

LIQUIDATION

12.1 INTRODUCTION AND MEANING

The winding up of business its members or its creditors. The assets are sold, liabilities settled as far as possible and any remaining cast returned to shareholders. A company can be liquidated even if it is viable (i.e., able to pay its debts) if it is believed to be preferable to distribute funds to the shareholders rather than carry on the business).

A Joint stock company comes into legal existence under the companies Act 1959. Being the creation of the law, it can cease to exist only through the process of law. The dissolution of the company is also regulated under the companies act. Under companies act, the dissolution of the company can place either.

1. By winding up Or

2. Without winding up under section 394 for facilitating reconstruction and amalgamation of companies.

3. By striking the deduct company's name off the Register by Register under Section 560.

The term liquidation debates the legal process by which the affairs of a company are wound up and the corporate life is brought to amend. Thus, winding up

of a company in the legally prescribed manner is known as liquidation. These two terms (winding up and liquidation) are interchangeably used.

NOTES

The Company is said to be in liquidation when winding up commences. It may be wound up by an order of court in which case it is called compulsory winding up. When the members of the company (alone or jointly with creditor) take steps to winding up the company, it is called Members Voluntary winding up or Creditors Voluntary winding up, as the case may be it may be wound up subject to the Supervision of the court.

The winding up of a company thus involves:

1. The ascertainment of its rights and liabilities.
2. The realization of its assets including the uncalled capital (if any)
3. The settlement of the surplus money left after the discharge in full of all outside liabilities) to its shares holders (called contributories) in accordance with the respective rights. The individual appointed to do all such things is termed as liquidators.

12.2 LIQUIDATORS OF FINAL STATEMENTS

The duties of the liquidator are

a) To release the amounts from the various properties and assets of the company
b) To discharge the liabilities an regulated in the companies act and
c) To adjust the rights and interest of the various contributions.

In every mode of winding up the liquidator is required to keep proper books in which he will record the receipts and payments. He has to submit an abstract there to

NOTES

the court in the case of a compulsory winding up and the to the company in a voluntary winding up. As soon s the affairs of the company are fully wound he makes his Final Statement of Account giving particulars of the amounts creditors and contribution of such realization amongst various creditors and contributories. This statement is known as Liquidator's Final Statement of Account.

While distributing the amounts realized the liquidator should adopt the following order :

1. To any the Secured creditors from the proceeds of their security
2. To pay Expenses of Liquidation including the remuneration (which consists normally of a commission on assets realized plus commission on the amount paid to the unsecured of the liquidator)
3. To pay the preference creditors.
4. To pay the Debenture holders
5. To pay the Unsecured Creditors
6. To distribute the surplus if any amongst the contributories according to their rights and interest.

Uncalled Capital may be called up by liquidator for the purpose of paying the creditors. The sale of partly paid shares does not relive the seller form his liability to pay the remaining calls for one year if the money cannot to collect from the person to whom he sold them. This is the reason for having the

"A" List Contributories and "B" List Contributories

The "B" List Contributories being those contributories two have ceased to be members within one years from the date of the commencement of the liquidation, while the "A" List Contributories give the present members.

NOTES

Shareholders are called Contributories where preference Shares have been issued the preference shareholders will be paid first in respect of their declared dividend and capital.

A liquidator ha Rs.1,122 to pay Rs.2,000 unsecured creditors. After he has received his remuneration on the amount realized, he entitled to a remuneration of 2 percent on the amount paid to unsecured creditors. What will the liquidators receive?

Answer

If the liquidator pays Rs. 100 he receives Rs. 2 thus absorbing Rs. 102.

Hence he receive $\frac{2}{102} \times 1{,}122$ = Rs. 22 thus leaving

Rs. 1,100 for distributions to the unsecured creditors.

The preparation of a liquidator's Final Statement of Account calls for no detailed explanation but the following matters require the attention of the student.

1. There is no double entry principle involved.
2. The sequence of items should correspond with that of the official form
3. The rights of various classes of shareholders (Particularly if there is a surplus require careful consideration
4. The remuneration of the liquidators is commission on the amount realized and further commission on the amount paid to Preference and Unsecured Creditors.

NOTES

Illustration: 1

Newgo Ltd which has a paid capital of Rs.1, 00,000 and a loss of Rs.1, 11,500 standing in its Balance Sheet went into Voluntary liquidation on 31st March 2008. The following are the particulars with regard to its assets and liabilities as on the above date. Machinery, Stock and Debtors (which realized their book values Rs.79,000 Cash Rs.1,000 Creditors Rs.40,000, 12% Debentures (which carry of floating charge) Rs.50,000 and interest accrued there on for 6 months Rs. 3,000. The above Debentures were paid off on September 2005 on this date a first and final dividend was also paid to the creditors Rs.5, 000 of the creditors are preferential and the rest are unsecured. The cost of liquidation amounted to Rs.500. The liquidator is entitled to 3% of the amount realized (i.e. excluding cash) from the date of assets and 2% of the amount distributed to the unsecured creditors (including preferential creditors) by way of his own remuneration. Prepare the Liquidator's Final Statement of Account.

Solution: Now go Ltd- Liquidator's Final Statement of Account.

	Rs.		Rs.
To Assets Realized	79,000	By Liquidation Expenses	500
Machinery Stock	1,000	By Liquidation Remuneration 3%	
Debtors cash		on Rs. 79,000 + 2% on Rs.23,675	
		i.e Rs. 2,370 + Rs. 473)	2,5843
		By Preference Creditors	5,000
		By Debentures holders having a	
		floating charge (Principal Rs.	
		50,000 plus interest Rs.3,000)	53,000
		By Unsecured Creditors	
		(being Rs. 0.53 in the rupee	
		i.e. 53% $\frac{18.657}{35,000}$ = x 100	18,657
	80,000		80,000

NOTES

The Liquidator has with him Rs.80, 000 before making any payment. He has to meet liquidation expenses to the extent of Rs.500. He is entitled deduct his commission of (3% on the amount realized)

3

Rs. 79,000 x ------- = Rs. 2,370, he has to pay off the Debentures

100

Holders Rs. 53,000. After meeting all these claims (Rs. 500 + Rs. 2,370 + Rs. 53,000) of Rs.55,870 out of Rs.80,000 the remaining amount works out Rs.24,130 Since the liquidators commission rends in priority to claims of the preferential Creditors and Unsecured Creditors the amount of this commission will be calculated as under.

2

------- = Rs. 24,130 = Rs. 473

102

This leaves Rs. 23,657 - Rs.473 for distribution to Preferential Creditors RS.5,000 and the balance Rs. 18,657 - Rs.4m000) of to unsecured. If 2% commission is calculated on Rs. 23,657 the figure obtained will be Rs.473.

N.B Since the amount is not sufficient to pay even the unsecured Creditors (Rs.40,000 - Rs.5,000) of Rs.35,000 fully nothing can be paid to the shareholders.

NOTES

Illustration: 2

The following particulars relate the limited company which has gone into voluntary liquidation. Liquidator's Signal Statement of Account allowing for his remuneration @ 2% on the amount related and 2% on the amount distributed to unsecured creditors others than preferential creditors.

	Rs.
Preferential Creditors	20,000
Unsecured Creditors	64,000
Debentures	20,000
The assets realized the following sums	
Land and Building	40,000
Plant & Machinery	37,300
Fixtures and Fittings	2,000
The Liquidation expenses amounted to Rs. 2,000	

Solution **Working Note: Calculation of commission**

	Rs.	Rs.
Total amount realized by selling assets		79,300
Less : Liquidator's remuneration @ 2% on assets released	1,586	
Liquidation Expenses	2,000	
Payments to Debentures holders	20,000	
Payment to Preferential Creditors	20,000	43,586
Balance		35,714
Less : Commission to Liquidator @ 2% on the amount to be paid to unsecured creditors i.e. $\frac{2}{102} \times 35.714$		700
Amount that can be paid to unsecured creditors		35,014

NOTES

Liquidation Final Statement Account

(Pursuant to section 497/509)

Receipt	Estimated value	Value Realized	Payments	Payment
	Rs.	Rs.		Rs.
Assets Realized:			Liquidator's Remuneration	
Land & Buildings	-	40,000	2% on 79,300 = 1,586	
Plant & Machinery	-	37,300	2% on 35,014 = 700	2,286
Fixture & Fittings	-	2,000	Liquidation Expenses	2,000
			Debentures holders having a floating charge	20,000
			Creditors :	
			Preferential 2,000	
			Unsecured creditors (547 paise in the rupee) 35,014	55,014
		79,300		79,300

NOTES

Illustration: 3

Lotus Ltd went into voluntary liquidation on July 17, 2009 At that date Balance sheet read follows.

Liabilities	Rs.	Asset	Rs.
Share Capital :		Plant	4,00,000
24,000, 10% Preference Shares		Stock	2,00,000
of Rs. Each	2,40,000		
40,000 Ordinary shares of		Debtors	3,00,000
Rs. 10 each	4,00,000		
5% Debentures	1,20,000	Cash at Bank	6,000
Creditors	2,06,000	Profit & Loss A/c	60,000
	9,66,000		9,66,000

The dividend on the preference shares had been paid up to June 30, 2008 The Liquidator sold the plant are stock for Rs.5,50,000 and realized all the debts except one Rs.50,000 which proved to be bad. He admitted the claim of all creditors, Rs.10, 000 of which were preferential.

Expenses of liquidation amounted to Rs.3, 000 and debentures were repaid on December 31, 2009. The liquidator's remuneration was at the rate of 2% on amount realized (except case) and 2% on the amount distributed to the ordinary shareholders. Prepare the Liquidator's Final Accounting for income tax. Under the Articles arrears of preference dividend are to be paid before anything is paid to shareholders, in the event of liquidation.

NOTES

Solution: Liquidator's Final Statement of Account Pursuant to Section 497/509

Receipt	Estimated value	Value Realized	Payments	Payment
	Rs.	Rs.		Rs.
Cash at Bank	6,000	6,000	Liquidator's Remuneration	
Trade Debtor	3,00,000	2,50,000	2% on 8,00,000 = 16,000	
Stock	2,00,000		25 on 1,90,004 = 3,800	19,800
Plant	4,00,000	5,50,000	Expenses of Liquidation	3,200
			Debentures holders	20,000
			Debentures 1,20,000	
			Interest 3,000	1,23,000
			Preferential Creditors	10,000
			Unsecured Creditors	1,96,000
			Payment to Contributors	
			Preference shareholders	
			including dividend for	
			2008-09	2,64,000
			Ordinary shareholders	1,90,000
		8,06,000		8,06,000

NOTES

Illustration :4

The over-confident Ltd. went into liquidation with the following liabilities:

(a) Secured creditors Rs.20,000 (securities realised Rs.25,000)
(b) Preferential Creditors Rs.600
(c) Unsecured Creditors Rs.30,500

Liquidator's expenses in connection with liquidation amounted to Rs.252. The liquidator is entitled to a remuneration of 3 percent on every amount realised and 1½ percent on the amount distributed to unsecured creditors except preferential creditors. The various assets (including securities in the hands of fully secured creditors) realised Rs.26,000. Prepare Liquidator's Account.

Ans: Note: Amount available to unsecured

Creditors:-

Rs.31,000 – Rs.1,530 – Rs.252 – Rs.600 = Rs.28,618. Whereas unsecured creditors to be paid is Rs.30,500. Therefore the company is able to given only Rs.28,618 after given 1.5% commission. Hence commission iscalculated on Rs.28,618 at 1.5 i.e. 28,618 x 1.5/101.5 =

Rs.423/-. The balance is payable to unsecured creditors i.e. Rs.28,618 – Rs.423 = Rs.28,195nt Account:

NOTES

Liquidators Final Statement

Receipts	Rs	Rs.	Payments	Rs.
Assets realized		26,000	Liquidators Remuneration	
Surplus from Secured Assets			3% on Assets realized	
Sale value	25,000		(26,000 + 25,000)	
(-) Loan	20,000		51,000 x 3/100	
	---------	5,000		1,530
			1.5% on unsecured Creditors	
			Unsecured Creditors	
			28,618 x 1.5/101.5	423
			Liquidation Expenses	252
			Creditors	
			Preferential Creditors	600
			Unsecured Creditors	28,195
		31,000		31,000

NOTES

12.3 STATEMENT OF AFFAIRS:

Where the court has made a winding up order or appointed the official liquidator as provisional liquidator, unless the court in its discretion otherwise orders, there shall be made out and submitted to the official liquidator a statement as to the affairs of the company in the prescribed form verified by an affidavit. This is known as statement of affair. This statement is to be submitted to the liquidator within 21 days from the date of the winding up order (or within such extended time not exceeding 3 months as the liquidator or the court permits).

The statement of affairs is always open to inspection by any person stating, in writing, to the creditor or contributory of the company, on payment of the prescribed fee. The statement of affairs must always be properly verified by an affidavit. However, the following steps are to be adopted in preparing the statement of affairs:

(i) Put down the assets which are not specifically pledged at their realized value. This includes the calls-in-arrears but does not include uncalled capital.

(ii) Add any surplus expected from securities available in the hands of secured creditors.

(iii) Out of the total amount realized, deduct first preferential creditors, then debentures having a

floating charge and then unsecured creditors.

(iv) After having paid to the unsecured creditors, deduct from the remaining surplus (or add to the deficiency) the amount of share capital.

(v) The balance left will be the surplus or deficiency.

NOTES

12.5 SHOW YOUR PROGRESS

1. What is Liquidation? Explain its procedure?
2. What is statement of affairs? How is it prepared?
3. What is Liquidator's final statement of account?

4. The following information is extracted from the books of a Siva company on June 30, 2008 on which date a winding up order was made:

	Rs.
Equity share capital, 80,000 shares of Rs. 10 each	8, 00,000
10% preference share capital 12,000 shares of Rs. 100 each	12, 00,000
Calls in arrears on equity shares (estimated to produce Rs. 8,000)	16,000
9% first mortgage debentures, secured by a floating charge on the Whole of the assets of the company	8, 00,000
Creditors fully secured (value of shares in X Ltd. Rs. 1, 60,000)	1, 40,000
Creditors partly secured (value of shares in Y Ltd. 80,000)	1, 60,000
Preferential creditors	30,000
Bank overdraft, secured by a second charge on the whole of the assets of the company	80,000
Unsecured creditors	10,40,000
Estimated liability on bill discounted	40,000
Cash in hand	8,100
Book debts - Good	1, 50,000

NOTES

- Doubtful (estimated to produce 40%)	30,000
Bad debts	18,000
Stock in trade (estimated to produce Rs. 2, 38,700)	2, 88,000
Freehold Land & Buildings (estimated to produce Rs. 7, 82,000)	6, 60,000
Plant & Machinery (estimated to produce Rs. 2.12, 000)	3, 00,000
Fixtures & fittings (estimated to produce Rs. 30,000)	50,000

Prepare a statement of affairs

(a) As regards creditors and (b) as regards contributories

Ans: Gross Assets Rs.16,80,800; Gross Liabilities Rs.22,90,000; Deficiency Rs.6,09,200.

LESSON-13

BANK ACCOUNTS

INTRODUCTION

"Bank" is a comprehensive term for a number of institutions carrying on certain kinds of financial business. In a narrow sense, it may be defined as the place for keeping money and valuable safely, the money being paid out on the customer's order, i.e., cheques. The Banking Regulation Act 1949 defines baking as "accepting, for the purpose of lending or investment, of deposits of money from the public repayable on demand or otherwise and withdraw able by cheque draft, order or otherwise". Therefore any company which engages itself in the manufacture of goods or carries on any trade and accepts deposits of money from the public for financing its business activities will not be treated as doing business of banking. Till 1949, there was no special legislation to regulate banking companies but since that year the Banking Regulation Act applies to corporate entities carrying on the business of banking in India. Such companies are also subject to the Companies Act 1956. All the nationalized banks are also governed by the Banking Regulation Act but regulations appointment of directions and disposal of profits etc., do not apply to them.

BUSINESS OF BANKING COMPANIES:

A bank deals in money. It buys and sells money in the same way as a trader buys goods for resale at a profit. It buys money from depositors and sells it to borrowers. Section 6 of the Banking Regulation Act contains a detailed list of the forms of business a banking company may carry on, in addition to its banking business. These forms of business are:

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Meaning of Bills of Exchange:

A document ordering the payment of money; drawn by one person or bank on another

i. Borrowing raising or taking up of money;

ii. Lending or advancing money;

iii. Drawing, making accepting, discounting, buying, selling, collecting and dealing in bills of exchange, hundis, promissory notes and other instruments.

iv. Granting and issuing of letters of credit, travelers cheques and circular notes;

v. Buying, selling and dealing in bullion,

vi. Buying and selling, on commission, underwriting and dealing in stock, shares, debentures, bonds, etc.,

vii. Receiving of all kinds of scrips or valuables on deposit or for safe custody;

viii. Providing of safe deposit values;

ix. Collecting and transmitting of money and securities;

x. Carrying on and transacting every kind of guarantee and indemnity business;

xi. Undertaking and executing trusts;

xii. Undertaking the administration of estates as executor, trustee or otherwise;

xiii. Contracting for public and private loans and negotiating and issuing the same;

xiv. The acquisition, construction, maintenance and alteration of any building or works necessary or convenient for the purpose of the company;

xv. Selling, improving, managing, developing, exchanging, leasing, mortgaging, disposing of or turning into accounts or otherwise dealing with all or any part of the property and rights of the company;

xvi. Acquiring and undertaking the whole or any part of the business of any person or company when such business is of a nature enumerated or described in this sub-section.

NOTES

xvii. Doing all such other things as are incidental or conductive to the promotion or advancement of the business of the company;

xviii. Any other form of business which the Central Government may, by notification in the "Official Gazette", specify as a form of business in which it is for a banking company to engage.

In this chapter, we are mainly concerned with the technique of preparing the final accounts of the banking companies;

LEGAL REQUIREMENTS

The important provisions relating to final accounts of a banking company are as follows:

1. Prescribed form: As per Section 29 to 33 of the Banking Regulation Act, every banking company is required to prepare a balance sheet in accordance with Form A set out in the Third Schedule and a Profit and Loss Account in conformity with form 15 of the same schedule. The formats have been revised w.e.f.1st April 1991. In other words, the final accounts for the year ending 31st March 1992 and onwards are to be prepared in the new formats.

2. Accounting Year: On account of the amended provision of the Income Tax Act 1961 requiring every company to close its accounts on 31st March each year, w.e.f. financial year ending 31st March 1989, now a banking company also closes its accounts on 31st March each year.

NOTES

3. Prohibition of Trading: According to Sec.8, a banking company cannot directly or indirectly deal in the business of buying and selling or bartering of goods, except in connection with the realization of security given to or held by it or engage in any trade or buy, sell or bather goods for others otherwise than in connection with bills of exchange received for collection or negotiation or for the administration of estates as executor, trustee or otherwise.

4. Non-banking Assets: A banking company may have to take possession of certain assets charges in its favor on account of the failure of a debtor to repay the loan in time. According to Sec.9, a banking company cannot hold any immovable property however acquired, except for its own use, for any period exceeding seven years from the date of acquisition thereof. Gain or loss on sale of such an asset has to be shown separately in the Profit and Loss Account of the banking company.

5. Share Capital: In order to ensure that no banking company commences or carries on business with a weak and vulnerable capital structure, Section 11 lays down the following minimum limits of paid up capital and reserves to be complied with by a banking company which wishes to commence or carry on business in India.

Types of Banking Aggregate

Value

of paid up

capital

and

reserves

NOTES

(1) In the case of a banking company incorporated Outside India:	
(a) If it has a place or places of business in the city of Bombay or Calcutta or both	20 lakhs
(b) If it has places of business elsewhere	15 lakhs
(2) In the case of a banking company incorporated in India	
(a) If it has places of business in more than one State and if it has a place or places of business in Bombay or Calcutta or both	10 lakhs
(b) If it has place of business in more than one state But not in Bombay or Calcutta	5 lakhs
(c) If it has all its places of business in one state none Of which is situated in the city of Bombay or Calcutta – for the Principal place of business	10 lakhs
(i) In respect of each of its other places of business Situated in the same district	10,000
Plus	
(ii) In respect of each places of business Situated Elsewhere in the state otherwise than in the same district	25,000
(d) If it has one place of business and that also not in Bombay or Calcutta	50,000
(e) If it has all its places of business in one state or more which is or are situated in the city of Bombay or Calcutta	5 lakhs
plus	

NOTES

In respect of each place of business situated	
Outside the city of Bombay or Calcutta as the	25,000
Case may be subject to an overall limit of	10 lakhs

The above requirements apply to those banks which were established before 1962. The banking companies (Amendment) Act 1962 raised the minimum amount of the value of the paid up capital to Rs.5 lakhs for any Indian Bank commencing business after the commencement of that Act.

(6) Reserve Fund: Every Year banking company incorporated in India is required under Section 17(1) of the Act to create a Reserve Fund and to transfer to such fund, before any dividend is declared, a sum of equal to not less than 25% of the profit, as disclosed in the Profit and Loss Account. Such reserve is termed as "Statutory Reserve". This section does not apply to banking companies incorporated outside India. The Central Government may, on the recommendation of the Reserve Bank, exempt a banking company from this restriction if the aggregate amount of reserves and share premium amount is not less than the paid up capital of the banking company.

(7) Payment of Dividend: Section 15 prohibits payment of dividend by any banking company until all of its capitalized expenses have been completely written off. These capitalized expenses include preliminary expenses, organization expenses, share-selling commission, brokerage, amounts of losses incurred and any other expenditure which is not represented by tangible assets. Payment of dividend out of the profits is considered inappropriate when capitalized expenses are outstanding.

A banking company may, however, pay dividends on its shares without writing off the following:

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(i) Depreciation in the value of its investments in approved securities where such depreciation has not actually been capitalized or otherwise accounted for as loss.

(ii) Depreciation in the value of its investments in shares, debentures or bonds other than approved securities) in any case where adequate provision for such depreciation has been made to the satisfaction of the auditors of the banking company.

(iii) Bad debts, if any, where adequate provision has been made to the satisfaction of the auditors of the banking company (Section 15).

(8) Payment of commission, Brokerage, etc: According to sec.13, a banking company cannot pay out directly or indirectly any commission, brokerage discount or remuneration in any form in respect of any shares issued by it, exceeding 2 ½ % of the paid up value of the shares.

(9) Charge on Uncalled Capital: Under Sec.14, a banking company cannot create any charge on unpaid capital and any such charge is invalid.

Under Sec.14A, banking company cannot create a floating charge on the undertaking or any property of the bank except with the written permission of the Reserve Bank of India certifying that the charge will not be detrimental to the interest of the depositors.

(10) Subsidiary Companies: In order to prevent the banking company from carrying on trading activities indirectly by acquiring controlling interest, it has

NOTES

been provided that a banking company can form a subsidiary company only for one or more of the following purposes:

i. The undertaking and executing of trust;

ii. The undertaking of the administration of estates as executor, trustee or otherwise;

iii. The carrying on business of banking exclusively outside India, with the prior permission of the Reserve Bank.

iv. Such other purposes as are incidental to banking business (Section 19)

11. Cash Reserves: Under Sec.18 every banking company (not being a scheduled bank) shall maintain a cash reserve with itself or with the Reserve Bank of the State Bank of India or any other bank notifies by the Central Government in this behalf a sum to at least 3% of its time and demand liabilities in India.

Under Sec.42, a Scheduled bank is also required to maintain with the Reserve Bank, an average daily balance of 3% of its total time and demand liabilities in India. The Reserve Bank has the power to increase this percentage upto 20% by a notification in the official gazette (At present CRR is 6% w.e.f. 2.3.07)

12. Statutory Liabilities Ratio: According to Sec.24 (2A) of the Banking Regulation Act, every banking company in India whether scheduled or non-scheduled, is required to maintain in India is cash, gold, or unencumbered approved securities an amount which Is not less than 25% of the total of its demand and time

NOTES

liabilities in India. This is known as "Statutory Liquidity Ratio". The Reserve Bank has the power to increase this ratio upto 40% At present, the norm for S.L.R, as per RBI I s25%.

13. Loans and Advances: Section 20 of the Banking Regulation Act, imposes certain restrictions on the loans granted by banks to persons connected with their management. This section as amended by the Amending Act of 1968 is as follows.

a. No banking company can grant loans and advances on the security of its own shares;
b. The banking company should not enter into any commitment for giving any loan or advance to;
    1. Any of its directors;
    2. To a firm in which any of its directors is interested as partner, manager, employee or guarantor.
    3. To any company of which any of the directors of the banking company is a director, manager, guarantor or
    4. To any individual with who any of its directors is a partner or a guarantor.

14. Limits as to Investments in Shares and Debentures: Reserve Bank of India has removed limits on investments made by the banks in the equity and debentures issue o f17 financial institutions. These include IDBI, IFCI, ICICI, EXIM Bank of India, IRBI, NABARD, NHB, UTI, LIC, GIC, RCTFC, TDICI, Tourism Finance Corporation of India etc.,

NOTES

The above restriction on granting of loans and advances were introduced by an amendment in 1968 in the Banking Regulation Act.

Preparation of Profit and Loss Account

Form 'B'

Third Schedule

Form of Profit and Loss Account

Profit and Loss Account for the year ended 31st March (000's omitted)

	Schedule No.	Year ended On 31.3….. (current year) Rs.	Year ended On31.3….. (previous year) Rs.
I. Income :			
Interest earned	13	xxxxxx	
Other Income	14	xxxxxx	

Total		------------	
II. Expenditure			
Interested expended	15	xxxxxx	
Operating expenses	16	xxxxxx	
Provisions and contingencies		xxxxxx	

Total		------------	
III. Profit / Loss:			
Net Profit / Loss (-) for the year		xxxxxx	
Profit / Loss (-) brought forward		xxxxxx	

Total		------------	
IV. Appropriations:			
Transfer to statutory reserves		xxxxxx	
Transfer to other reserves		xxxxxx	
Transfer to Govt. / proposed dividend		xxxxxx	
		xxxxxxx	
Balance carried over to balance sheet		------------	

Total			

NOTES

Schedules to be annexed with Profit and Loss Account

Schedule 13: Interest Earned

	Year ended On 31.3..... (current year) Rs. In 000	Year ended 31.3..... (previous year) Rs. In '000
I. Interest / Discount on Advances / Bills	xxxx	
II. Income on Investments	xxxx	
III. Interest on balances with RBI and other Inter –bank funds	xxxx	
IV. Others	xxxx	
	-----------	-----------
Total	xxxx	
	-----------	-----------

Schedule 14: Other Income

		Year ended On 31.3..... (current year) Rs. In 000	Year ended 31.3..... (previous year) Rs. In '000
I. Commission, Exchange and Brokerage	xxxx		
II. Profit on sale of investments	xxxx	xxxx	
LESS: Loss on sale of investments	xxxx		

III. Profit on revaluation of investments	xxxx		
LESS: Loss on revaluation of investments	xxxx	xxxx	

IV. Profit on Sale of Land /Building and Other assets	xxxx		
LESS: Loss on sale of Land, Building and other assets	xxxx	xxxx	

V. Profit on Exchange transaction	xxxx		
LESS: Loss on Exchange transactions	xxxx	xxxx	

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VI. Income earned by way of dividends etc From subsidiaries / companies and or Joint Venture abroad / in India.	xxxx	
VII. Miscellaneous Income	xxxx	
Total	------------ ------------	------------ ------------

Note: Under items II to V, loss figure may be shown in brackets.

Schedule 15: Interest Earned

	Year ended On 31.3….. (current year) Rs. In 000	Year ended 31.3….. (previous year) Rs. In '000
i. Interest on Deposits	xxxx	
ii. Interest on RBI / Inter-Bank Borrowings	xxxx	
iii. Others	xxxx	
Total	------------ ------------	------------ ------------

Schedule 16: Operating Expenses

	Year ended On 31.3..... (current year) Rs. In 000	Year ended 31.3..... (previous year) Rs. In '000
i. Payments to and provisions for employees	xxxx	xxxx
	xxxx	xxxx
ii. Rent, taxes and lighting	xxxx	xxxx
iii. Printing and Stationery	xxxx	xxxx
iv. Advertisement and Publicity	xxxx	xxxx
v. Depreciation on banks property	xxxx	xxxx
vi. Directors fees allowances and expenses	xxxx	xxxx
vii. Auditor fees allowances and expenses	xxxx	xxxx
viii. Law charges	xxxx	xxxx
ix. Postage, telegrams, telephones, etc.	xxxx	xxxx
x. Repairs & Maintenance	xxxx	xxxx
xi. Insurance	xxxx	xxxx
xii. Other expenditure	-----------	------------
	-	------------
Total	-----------	
	-	

Preparation of Profit and Loss Account

Illustration: 1

From the following particulars prepare Profit and Loss A/c of New Bank Ltd., for the year ended 31.12.1996.

	Rs(in"000)		Rs. (in'000)
Interest on loans	260	Interest on cash credits	200
Interest on fixed deposits	280	Rent and taxes	20
Rebate on bills discounted	50	Interest on Overdrafts	56
Commission charges to customers	9	Directors and Auditors fees	4
Establishment expenses	56	Interest on saving bank	
Discount on bills discounted	200	Accounts	70
Interest on current accounts	45	Postage and telegrams	2
Printing and advertisements	3	Sundry charges	2

NOTES

Solution

New Bank Ltd., Profit and Loss Account for the year ended 31.12.1996

	Schedule No.	Year ended On 31.12.1996 (current year) Rs.	Year ended On 31.12.1995 (previous year) Rs.
I. Income :			
Interest earned	13	741	
Other Income	14	9	
Total		750	
II. Expenditure			
Interested expended	15	395	
Operating expenses	16	87	
Provisions and contingencies			
Total		482	
III. Profit / Loss:			
Net Profit for the year (I – II)		268	
. Profit brought forward		---	
Total		268	
IV. Appropriations:			
Transfer to statutory reserves (25% of 268)		67	
Transfer to other reserves			
Transfer to Govt. / proposed dividend			
Balance carried over to balance sheet		201	
Total		268	

Note: Transfer to statutory reserve in not increased to 25% of Net Profit from the earlier 20%

NOTES

Illustration-2

From the following information relating to Lakshmi Bank Ltd., prepare the Profit & Loss A/c for the year ended 31st December, 1987.

	Rs.		Rs.
Rent received	72,000	Salaries and allowances	2,18,800
Exchange and commission	32,800	Postage	5,600
Interest on fixed deposits	11,00,000	Sundry charges	4,000
Interest on savings bank A/c	2,72,000	Director's & Auditor's fees	16,800
Interest on overdrafts	2,16,000	Printing	8,000
Discount on bills discounted	7,80,000	Law charges	3,600
Interest on current accounts	1,68,000	Locker Rent	1,400
Interest on cash credits	8,92,000	Transfer fees	2,800
Depreciation on bank property	20,000	Interest on loans	10,36,000

NOTES

Solution

The Lakshmi Bank Ltd.

Profit and Loss Account

For the year ended 31st December 1987

	Schedule No.	Year ended 31st December 1987 Rs.
I. Income		
Interest earned	13	29,24,000
Other income	14	1,09,000
Total		30,33,000
II. Expenditure		
Interest expended	15	15,40,000
Operating expenses	16	2,76,800
Provisions and contingencies		-
		18,16,800
III. Profit / Loss		
Net profit for the year (I-II)		12,16,200
Profit brought forward		-
		12,16,200
IV. Appropriations		
Transfer to statutory reserve (25% of net profit)		3,04,050
		-
Transfer to other reserves		-
Transfer to government/proposed dividend		9,12,150
Balance carried over to Balance Sheet		12,16,200

Note: Transfer to Statutory Reserve has been increased to 25% recently.

NOTES

Working notes

Schedule 13: Interest earned

	Rs.
Interest on overdrafts	2,16,000
Discount on bills discounted	7,80,000
Interest on cash credits	8,92,000
Interest on loans	10,36,000
	29,24,000

Schedule 14: Other Income

	Rs.
Locker Rent	1,400
Transfer fees	2,800
Exchange and commission	32,800
Rent	72,000
	1,09,000

Schedule 15: Interest expended

	Rs.
Interest on fixed deposits	11,00,000
Interest on savings bank accounts	2,72,000
Interest on current A/c	1,68,000
	15,40,000

NOTES

Schedule 16: Operating expenses

	Rs.
Depreciation on bank property	20,000
Salaries and allowances	2,18,800
Postage	5,600
Sundry charges	4,000
Director's and Auditor's fees	16,800
Printing	8,000
Law charges	3,600
	2,76,800

Illustration=3

The following figures are extracted from the books of Bheema Bank Ltd. As on 31.12.1987.

	Rs.
Interest and discount received	36,95,738
Commission, exchange and brokerage	2,00,000
Directors' fees and allowances	55,000
Postage and telegrams	62,313
Stationery	17,625
Preliminary expenses	15,000
Interest paid on deposits	20,32,542
Rent received	55,000
Salaries and allowances	1,75,000
Rent and taxes paid	87,973
Profit on sale of investments	2,00,000
Depreciation on building	27,375
Audit fees	5,000

Additional information:

(1) A customer to whom a sum of Rs.10,00,000 has been advanced has become insolvent. It is expected that only 50% can be recovered from his private estate.

(2) For the remaining debts, a provision of Rs.1,50,000 was necessary.

(3) Rebate on bills discounted as on 31.12.86 Rs 12,000 and on 31.12.1987 Rs. 16,000.

(4) Provide Rs.6,50,000 for taxation.

(5) Write off all preliminary expenses.

Prepare Profit & Loss A/c in accordance with the law.

NOTES

Solution

Bheema Bank Ltd.

Profit & Loss A/c for the year ended 31.12.87

	Schedule No.	Year ended 31.12.1987(current year) Rs.
I. Income:		
Interest earned	13	36,91,738
Other Income	14	4,55,000
Total		41,46,738
II. Expenditure:		
Interest expended	15	20,32,542
Operating expenses	16	4,45,286
Provisions & Contingencies		13,00,000
Total		37,77,828
III. Profit /Loss:		
Net profit for the year (I-II)		3,68,910
Profit brought forward		-
Total		3,68,910
IV. Appropriations:		
Transfer to statutory reserves (25% of 3,68,910)		92,228
		-
Transfer to other reserves		-
Transfer to Government/proposed dividend		2,76,682
Balance carried over to Balance sheet		3,68,910

Note: Transfer to Statutory Reserve is now at 25%.

NOTES

Working Notes **Schedule 13: Interest earned**

	Rs.
Interest and discount received	36,95,738
Add: Rebate On bills discounted on 31.12.86	12,000
	37,07,738
Less: Rebate on bills discounted on 31.12.87	16,000
	36,91,738

Schedule 14: Other income

	Rs.
Commission, exchange & brokerage	2,00,000
Rent received	55,000
Profit on sale of investments	2,00,000
	4,55,000

Schedule 15: Interest expended

	Rs.
Interest paid on deposits	20,32,542
	20,32,542

Schedule 16: Operating expenses

	Rs.
Directors' fees and allowances	55,000
Postage and telegrams	62,313
Stationery	17,625
Preliminary expenses	15,000
Salaries and allowances	1,75,000
Rent & taxes paid	87,973
Depreciation on building	27,375
Audit fees	5,000
	4,45,286

NOTES

Provisions and Contingencies

	Rs.
Bad debts (10,00,000 *50%)	5,00,000
Provision for bad debts	1,50,000
Provision for taxation	6,50,000
	13,00,000

Illustration-4

On 31st December 1986. The following balances stood in the books of Asian Bank Ltd., after preparation of its profit and Loss Account.

	Rs.(in '000)
Share capital:	
Issued and subscribed	4,000
Reserve fund (under section 17)	6,200
Fixed deposits	42,600
Savings bank deposits	19,000
Current accounts	23,200
Money at call and short notice	1,800
Investments	25,000
Profit and Loss Account (Cr) 1st Jan 1986	1,350
Dividend for 1985	400
Premises	2,950
Cash in hand	380
Cash with RBI	10,000
Cash with other banks	6,000
Bills discounted and purchased	3,800
Loans, cash credits and overdrafts	51,000
Bills payable	70
Unclaimed dividend	60
Rebate on bills discounted	50
Short loans(borrowing from other banks)	4,750
Furniture	1,164
Other assets	336
Net Profit for 1986	1,550

Prepare balance sheet of the bank as on 31st December 1986.

NOTES

Solution

Asian Bank Ltd.

Balance sheet as on 31.12.1986

(000's omitted)

	Schedule No.	As on 31.12.86 (Rs. In '000)
Capital and Liabilities:		
Capital	1	4,000
Reserves	2	8,700
Deposits	3	84,800
Borrowings	4	4,750
Other Liabilities & Provisions	5	180
		1,02,430
Assets:		
Cash and balance with RBI	6	10,380
Balance with Banks & Money at call and short notice	7	7,800
Investments	8	25,000
Advances	9	54,800
Fixed assets	10	4,114
Other assets	11	336
		1,02,430
Contingent Liabilities	12	Nil
Bills for collection		Nil

Working notes:

(Rs. In '000)

Schedule 1: Capital

Issued and subscribed share capital	4000

Schedule 2: Reserves and surplus

		Rs.
Reserve fund		6,200
Profit and Loss A/c (1.1.86)	1,350	
Less : Dividend for 1985	400	

	950	
Add: Net profit for 1986 after deducting statutory Reserve [15,50,000-(15,50,000*25%)]	1,162.5	
	----------	2,112.5
Statutory reserve		387.5
		8,700.0

Note : Transfer to statutory reserve now is at 25% of Net Profit.

NOTES

Schedule 3: Deposits

	Rs.
Fixed deposits	42,600
Savings Bank deposits	19,000
Current accounts	23,200
	84,800

Schedule 4: Borrowings

Short loans	4,750

Schedule 5: Other Liabilities and Provisions

Bills payable	70
Unclaimed dividend	60
Rebate on bills discounted	50
	180

Schedule 6: Cash and balances with RBI

Cash in hand	380
Cash with RBI	10,000
	10,380

NOTES

Schedule 7: Balance with banks and money at call and short notice

Money at call and short notice	1800
Cash with other banks	6000
	7800

Schedule 8: Investments

Investments	25000
	25000

Schedule 9: Advances

Bills discounted and purchased	3,800
Loans, cash credits and overdrafts	51,000
	54,800

Schedule 10: Fixed Assets

Premises	2,950
Furniture	1,164
	4,114

Schedule 11: Other assets

Other assets	336

Schedule 12: Contingent Liabilities

Bills for Collection	Nil

NOTES

Exercise

1. The following are the balances from the books of X Bank Ltd., as on 31st December 1985.

	(Rs. In
Current deposits	'000)
Savings account	22,750
Fixed deposit	8,260
Compulsory deposit of I.T tax payers	17,590
Sundry creditors	1,000
Debts due to banks(secured)	228
Bills receivable	6,100
Customer Liability for acceptance	9,050
Rebate on bills discounted	7,584
Branch adjustments (credit)	7.5
Reserve fund	2,277
Capital (authorized issued, subscribed and paid up)	6,250
1,00,000 shares of 50 each	
Interest and discount received	5,000
Exchange and commission received	2,900
Profit and loss account (balance on 1.1.1985)	877.5
Cash on hand	426
Cash at bank	653.5
Bills receivable	3,000
Liability for customers acceptance	9,050
Investments:	7,584
Government securities	
Shares	18,000
Interest accrued on investment	7,950
Loan	437.5
Bills purchased and discounted	20,850
Furniture, fixtures and office equipment	17,750
Depreciation on assets	250
Interest paid	250
Exchange and commission paid	600
Salaries	50
Director's fees	1,200
Stationery, postage, etc.	50
Miscellaneous expenses	200
Land and Building	150
Money at call	1500
Non – banking assets	750
	25

NOTES

Prepare Profit and Loss account for the year ending December 31, 1985 and Balance Sheet as at that date making note of the following:

Provision needed for taxation Rs.5, 00,000

Current account includes Rs.42, 50,000 debit balance being overdraft.

One of the account Rs.50, 000(including interest Rs.5, 000) is doubtful.

During the year a property was acquired in satisfaction of a claim amounting to Rs.25, 000 and was sold for Rs.18, 000. The loss resulting there from remained unadjusted in the books.

NOTES

LESSON-14

HOLDING COMPANY ACCOUNTS

What is Holding ompany?

A company with ontrolling shares in ther companies

INTRODUCTION

Economies of Large scale production have given impetus to business combinations. Mergers and acquisitions have become the order of the day in the corporate world. Acquiring controlling interest in a company provides control over its working without affecting its independent existence and identity. The Holding company method of business combination facilitates creation of closely linked group of companies with interest in mutual well being. Thus, acquiring control over other companies has become a favorite method to go build up an industrial empire.

MEANING AND DEFINITION OF HOLDING COMPANY AND SUBSIDIARY COMPANY

A holding company is one which controls one or more other companies by means of:

a) Holding majority share or

b) Controlling the composition of Board of directors or

c) Controlling a holding company with subsidiaries

The Indian company Act does not define a holding company directly. Sec. 4 (4) of the companies Act says, "A Company shall be deemed to be the holding company of another, if, but only if, that other is its subsidiary."

NOTES

According to Sec.4 (1) OF THE Companies Act, a company is a subsidiary of another company if, but only if,

a) The other company controls the composition of its board of directors or
b) The other company

i)Holds more than half in nominal value of its equity share capital or

ii) If it is a company formed before 1st April 1956 with both equity and preference shareholders having the same voting rights, the other company exercise or controls more than half of its voting power, or

iii) It is a subsidiary of any company which is that other company's subsidiary.

For example, if company "A" is subsidiary of company "B" and company "C" is a subsidiary of company "A" then company "C" becomes subsidiary for company "B" also indirectly. Such a subsidiary may be called sub-subsidiary or deemed subsidiary.

Legal requirements relating to presentation of accounts

Section 212 of the Companies Act lays down specifically the different aspects of presentation of accounts by a holding company.

1. A holding company has to attach the following documents with its balance sheet in respect of each of its subsidiaries.

NOTES

a) A copy of the Balance sheet of the subsidiary

b) A copy of the profit and Loss account

c) A copy of the report of its board of directors

d) A copy of the report of its auditors

e) A statement of the holding company's interest in the subsidiary as specified in sub-section (3)

f) The statement referred to in sub-section (6) if any

2: If the financial years of the holding company and subsidiary coincide with each other, subsidiary company's Balance sheet and other documents mentioned above relating to the same financial year should be attached to the Balance sheet of the holding company

If the financial year of both the companies does not coincide, the preceding year's Balance sheet and other statements of the subsidiary must be attached. However the time span between the two balance sheets should not be more than six months.

PREPARATION OF CONSOLIDATED BALANCE SHEET

The following are the various points to be considered and followed for the preparation of consolidated Balance sheet of a holding company and its subsidiaries.

1. Basic philosophy of consolidation-Elimination of investment account.

NOTES

Usually a holding company shows the shares acquired in a subsidiary as an investment on the assets side of its Balance sheet. This shows the amount paid by the holding company for the shares acquired in the subsidiary. But the details of the acquisition are absent. Consolidation aims at providing full details about the investment as a part of the Balance sheet itself. This is done by "replacing" the investment account with the individual assets and liabiliti9es of the subsidiary company. These assets and liabilities are clubbed with those of the holding company itself to provide a complete picture.

2. Minority interest

a) **Meaning:** Usually, a holding company acquires majority equity shares in a subsidiary, representing the controlling interest. The remaining shares may be in the hands of the general public. Such holding of the general public in the subsidiary company is called "Minority Interest".

b) **Treatment:** The minority interest is to be computed and shown on the liabilities side of the consolidated Balance sheet as a separate item. It may be shown as the last item on the liabilities side or along with the share capital of the holding company. The former method is more popular:

Computation: Usually the tollowing items constitute the minority interest:

Face value of minority equity shares.	xxx
Face value of minority preference shares	
Minority share of capital profits	xxx
Minority share of Revenue profits	
Minority share of bonus shares issued	xxx
	xxx

NOTES

		xxx
		xxx
Less: Minority share of capital losses	xxx	
Minority share of revenue Losses	xxx	
		xxx
Total Minority Interest		xxx

3. **Cost of control or goodwill:**

(a) Meaning: When holding company acquires majority of the shares in a subsidiary, it may be forced to pay more than the face value and even the book value of such shares. The demand and supply equation operates here. The demand for the subsidiary company's shares generated in the process of acquiring controlling interest in the subsidiary 'pushes up' the market price of such shares. Thus, cost of control is the 'penalty' or 'excess' paid by the holding company to acquire 'controlling interest' in the subsidiary company.

(b) Treatment: The excess amount paid is usually treated as 'goodwill' and is shown on the assets side of the consolidated Balance Sheet along with any goodwill in the holding company's Balance Sheet.

If the price paid by the holding company for shares acquired in the subsidiary is less than 'what is received in return' in the form of the face value of shares purchased and the

holding company's share of the capital profits, such difference is a capital gain. Such capital profit can be reduced from any goodwill existing in the Balance Sheet of the holding and subsidiary companies. If the capital profits are in excess of such goodwill or there is no goodwill in the balance sheets, it must be shown as 'capital reserve' in the liabilities side of the consolidated Balance Sheet.

NOTES

(c) Computation: The following is the usual method of ascertaining cost control or capital reserve.

		Rs.
Amount paid for shares purchased by the holding company in the subsidiary		xxx
Add: Holding company's share of capital loss		xxx
		xxx
Less: Face value of shares purchased	xxx	
Holding company's share of capital profits	xxx	
Holding company's share of Bonus Shares issued By subsidiary	xxx	
Holding company's share of dividend paid out of Capital profits	xxx	
	-------	xxx
Goodwill or Capital Reserve		xxx

Note: If the Balance is positive, it is goodwill. If it is negative, it is capital profit to be treated as capital reserve.

The goodwill or capital reserve ascertained here must be merged with any goodwill in the balance sheets of the holding company and the subsidiary companies.

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NOTES

4. **Revenue profits or post acquisition profits:**

Meaning: Profits earned by a subsidiary company after the date of acquisition of shares by the holding company are called revenue profits or post acquisition profits. These profits may be part of the Profit & Loss account of the subsidiary company or they might have been transferred to reserves or proposed as dividend.

Treatment: The revenue profits have to be divided in the ratio of shares held by the holding company and the minority in the subsidiary, generally known 'Holding minority ratio'. The minority share is added in computing minority interest. The holding company's share is added to the holding company's Profit and Loss Account in the consolidated Balance Sheet.

Computation: If shares are purchased by the holding company on the date of the given Balance sheets, revenue profits are 'Nil'. If shares are purchased during the 'current year', profits proportionate to the number of months after the purchase of shares are treated as revenue profits. If the shares were acquired at the beginning of the current year, entire profit of the current year has to be treated as revenue profits. If exact date of purchase of shares is not given, other details about profits have to be seen to determine the revenue profits.

5. Revenue losses or post acquisition losses:

Any loss incurred by the subsidiary company after the date of purchase of shares by the holding company is called 'revenue loss' or 'post acquisition loss'.

Revenue loss has to be divided in the 'Holding minority ratio'. Minority share has to be subtracted while ascertaining minority interest. Holding company's share has to be reduced from its Profit & Loss account in the consolidated Balance Sheet. If Profit & Loss Account does not show any credit balance, the revenue loss may be shown on the assets side of the consolidated Balance sheet under miscellaneous expenditure.

6. Capital Profits and Losses or pre acquisition Profits & Losses:

Meaning: All the accumulated profits of the subsidiary company on the date of purchase of shares by the holding company are called 'capital profits' or 'pre acquisition profits'. They may be in the form of capital reserve, general reserve, reserve fund, share premium, Profit & Loss account, etc. if shares are acquired during the current year, profit earned by the subsidiary in the months before purchase of shares in the current year is also to be taken as capital profit. Similarly, any profit on revaluation of assets or liabilities on the date of purchase of shares has to be treated as capital profit.

NOTES

All accumulated losses on the date of purchase of shares by the holding company are termed as 'capital losses'. Similarly, any loss incurred in the current year before purchase of shares is also capital loss. Any loss on revaluation of assets and liabilities at the time of purchase of shares is also to be treated as capital loss.

Treatment: Any Bonus shares issued, and dividend paid out of the capital profits has to be subtracted and the balance of capital profit or loss has to be divided in the 'holding minority ratio. Minority share of the capital profits has to be added to the minority interest. Similarly, minority share of capital loss has to be subtracted in the computation of minority interest.

Holding company's share of capital profit is to be reduced while ascertaining cost of control. This is due to the fact that accumulated profits of the subsidiary must have influenced the price paid for the shares acquired. Based on the same logic, holding company's share of capital loss is added in the computation of cost of control.

NOTES

Computation: Capital profits are usually computed as follows:

	Rs.
General reserve, capital reserve, P&L A/c and other reserves of subsidiary on the date of purchase of shares	Xxx
Less: Bonus shares issued by subsidiary from pre acquisition profits xxx Dividend paid by subsidiary out of pre acquisition profits xxx ------	Xxx
Add: Subsidiary company profits during the current year before purchase of Shares	Xxx
Add: Profit on revaluation of assets and liabilities of the subsidiary on the Date of purchase	Xxx
Loss: Loss on revaluation of assets and liabilities of subsidiary on the date of purchase	Xxx
Net capital profits	Xxx

7. **Revaluation of assets and liabilities:**

When holding company acquires controlling interest in a subsidiary, it may revalue the assets and liabilities to reflect their current values. These revised values may form the basis for determining the value of shares for the purpose of acquisition.

Any profit or loss on revaluation of the assets and the outside liabilities has t be adjusted in the respective assets and liabilities in the consolidated Balance Sheet, if it is not

already done. The same profit or loss has to be included in the computation of 'capital profits', as already explained earlier.

Depreciation on Revalued Assets:

The changes in the value of any fixed assets as on the date of purchase of shares create the problem of 'depreciation'. If there was appreciation on the fixed assets due to revaluation, additional depreciation from the date of revaluation till the Balance Sheet date has to be provided. This additional depreciation has to be reduced from 'Revenue profits' because the depreciation is related to the post acquisition period.

If there was decrease in the value of fixed assets on revaluation, the depreciation attributable to the 'decreased' portion of the asset has to be calculated and added to the revenue profits.

In the combined Balance sheet, these, additional depreciation or 'saving in depreciation' have to be adjusted in the assets concerned.

8. Bonus shares issued by subsidiary company: After the holding company acquired controlling interest, subsidiary company may issue bonus shares out of its profits to all the shareholders. As a result, holding company also receives the bonus shares and the face value of shares acquired increases.

Treatment: Treatment of bonus issue by subsidiary depends on the source of profits out of which the bonus is issued.

(a) Bonus issue out of capital profits: It has no real effect on the consolidated Balance Sheet. The amount of bonus is reduced from capital profits. The same amount is added to the face value of shares acquired in the subsidiary. Thus, while computing cost of control, Face value of shares held by the holding company increases and the holding company's share of capital profits decreases to the same extent. (See illustration Nos. 8, 10, 13, &15.)

Minority share of the bonus is added to the minority interest.

(b) Bonus issue out of revenue profits or post acquisition profits: This type of bonus issue has its impact on the consolidated Balance Sheet. The amount of bonus has to be reduced from revenue profits before distributing the revenue profits in the holding minority ratio.

Minority share of the bonus is added to the minority interest. Holding company's share of the bonus is subtracted in the calculation of 'cost of control'. The net effect is that goodwill decreases to the extent of the holding company's share of the bonus, though the bonus is not out of the pre acquisition profits(See illustration No.12).

9. Dividends from subsidiary company:

Subsidiary company may declare and pay dividend to its shareholders, after the holding company acquired shares in the subsidiary. It may be dealt with as follows:

(a) Proposed dividend: Dividend might have been proposed, but not yet paid by the subsidiary. Such proposed dividend need not be separately treated. It should be added to the respective revenue profits and capital profits as the case may be. So, minority share of the proposed dividend becomes a part of

NOTES

the minority interest. Holding company's share merges into the revenue and capital profits of the holding company.

(b) Capital dividend (or) Dividend paid by subsidiary out of pre-acquisition profits: Since the amount is already received, minority share of the capital dividend has to be ignored.

Holding company's share of the capital dividend is credited to investment account representing the shares in subsidiary company. The effect is that cost of control or goodwill is reduced to that extent. Otherwise, capital reserve increases to the extent of the dividend received by the holding company.

Usually, when the dividend is received, holding company might have included it in its Profit & Loss account. So, the holding company's share of the capital dividend which was credited to its Profit & Loss Account should be subtracted from Profit & Loss account in the consolidated Balance Sheet.

(c) Revenue dividend or dividend paid by subsidiary out of post acquisition profits: Since the amount of dividend is already received minority share of the revenue dividend has to be ignored.

Holding company's share of the revenue dividend is already received minority share of the revenue dividend has to be ignored.

Holding company's share of the revenue dividend has to be credited to its profit & loss account. If it was already credited to Profit & Loss account at the time of receiving, no further adjustment is required.

NOTES

The revenue dividend has to be reduced from the post acquisition profits before dividing them between the holding company and the minority.

(d) Composite dividend: Dividend paid by the subsidiary company may be partly out of capital profits and partly out of revenue profits. In such a case, the dividend has to be divided into two portions. The capital dividend portion and the revenue dividend portion have to be dealt with separately, as indicated above.

(e) If there is no indication regarding the source of profits for the dividend paid by the subsidiary, it must be assumed that the dividend amount was earned during the period for which it was declared. Thus, interim dividend must be presumed to be out of current year's profits. Dividend paid for previous year must be out of profits earned before the current year.

10.Preference shares in subsidiary company

Holding company may acquire all or a part of the preference shares in subsidiary company, apart from purchasing controlling interest in the equity shares.

While ascertaining cost of control, amount paid by the holding company is added to the amount paid for equity shares. Face value of preference shares acquired is reduced. The net effect is that any difference between the amount paid and the face value of the shares merges into the goodwill or capital reserve. Any dividend due on the preference shares till the date of acquisition should also be reduced in the computation for cost of control, after subtracting it from capital profits. Dividend due on the preference shares for the post acquisition period is to be treated like revenue dividend payable.

NOTES

Minority share of the preference shares is included in the minority interest, along with any pre acquisition dividend payable to the minority.

11. Debentures in subsidiary company: Subsidiary company may have debentures in its Balance Sheet liabilities side. They are just like any other liability to outsiders and must be shown in the consolidated balance sheet. However, if the holding company has purchased a part or all of them, such debentures should be eliminated from the consolidated Balance sheet, just like any other mutual obligation which is explained below separately.

12. Elimination of common transactions or mutual obligation or mutual indebtedness:

The holding company and the subsidiary companies may owe money to each other due to common transactions like buying and selling of goods. Lending and borrowing of money, rendering service to each other etc. all such mutual obligations have to be eliminated from the consolidated balance sheet.

(a) Debtors and creditors: The debtors and creditors of holding and subsidiary companies may include amount payable and receivable between them for purchase and sale of goods. If it is the same amount shown by both the companies, it can be reduced on both sides of the consolidated balance sheet. If there is any difference between the amounts, it must due to cash in transit or goods in transit. In such a case transit amount should also be reduce from the side on which higher amount is shown. The cash in transit in such

NOTES

Illustration- 1

The Balance Sheets of C Ltd. And D Ltd. as at 31st December 1986 are as follows:

Liabilities	C Ltd Rs.	D Ltd Rs.	Assets	C Ltd Rs.	D Ltd Rs.
Share Capital (in			Sundry assets	1,32,500	1,38,200
shares of Rs. 10 each	2,00,00	1,00,00	Goodwill	----	20,000
General reserve	0	0	Shares in		
Profit & Loss A/c	18,000	20,000	D Ltd at cost	1,40,000	----
Creditors	24,500	23,000			
	30,000	15,200		-----------	-----------
	----------	----------		2,72,500	1,58,200
	-	-		-----------	-----------
	2,72,50	1,58,20			
	0	0			
	----------	----------			
	-	-			

In the case of 'D' Ltd profit for the year ended 31st December 1986 is Rs.12, 000/- and transfer to reserve is Rs.5,000/-. The holding of C Ltd in D Ltd I s90% acquired on 30th June 1986.

Solution

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
Share Capital :					
20,000 shares of			Goodwill		36,700
Rs. 10 each		2,00,000			
General reserve		18,000	Sundry		
Profit & Loss A/c	24,500		Assets	1,32,500	
Add. 'C' Ltd.'s shares			C Ltd	1,38,200	2,70,700
of revenue profit	5,400	29,900	D Ltd		
Creditors:					
C Ltd	30,000				
D Ltd	15,200	45,200			
Minority Interest		14,300			
		-----------			-----------
		3,07,400			3,07,400
		-----------			-----------

NOTES

Working Notes:

1. Holding minority ratio

C Ltd acquired 90% of share in D Ltd
Minority holding in D Ltd = 10%

Ratio = 90: 10 or 9: 1

2. Revenue Profits

		Rs.
Profit for the current year given		12,000
Profit made after June 30th or revenue profit	$= 12{,}000 \times \dfrac{6}{12} =$	6,000
Holding company's share	$= 6{,}000 \times \dfrac{9}{10} =$	5,400
Minority Company's share	$= 6{,}000 \times \dfrac{1}{10}$	600

3. **Capital Profits**

	Rs.
General Reserve of D Ltd	20,000
Profit & Loss Account of D Ltd	23,000

	43,000
Less Revenue Profit	6,000

Capital Profit	37,000

NOTES

Holding company's share $= 37{,}000 \times \frac{9}{10} = 33{,}300$

Minority's share $= 37{,}000 \times \frac{1}{10} = 3{,}700$

Note: Since it is clearly stated that the profit of D Ltd for the year 1986 is Rs.12, 000, it is assumed that the transfer to reserve of Rs.5, 000 is a part of the Rs.12, 000

4. Minority Interest

Face value of minority shares $1{,}00{,}000 \times \frac{10}{100} =$	Rs.10, 000
Add: Minority share of capital profit	3,700
Add: Minority share of revenue profit	600
Minority interest	14,300

NOTES

5. Cost of control or good will

			Rs.
	Amount paid by C Ltd for shares purchased in D Ltd		1, 40,000
Less	Face value of shares purchased $1,00,000 \times \frac{90}{100}$ = 90,000		
Less	Holding company's shares of capital profits	= 33,300	
			1, 23,300
	Good will		16,700
Add:	Good will in D Ltd.'s Balance Sheet		20,000
	Good will to be shown in consolidated Balance Sheet		36,700

Illustration – 2

On 31st March 1996 the balance sheets of H Ltd and its subsidiary S Ltd stood as follows:

Liabilities	H Ltd Rs.	S Ltd Rs.	Assets	H Ltd Rs.	S Ltd Rs.
Equity Share Capital	8,00,000	2,00,000	Fixed assets	5,50,000	1,00,000
General reserve	1,50,000	70,000	75% shares in S Ltd (at cost)	2,80,000	----
Profit & Loss A/c	90,000	55,000	Stock	1,50,000	1,77,000
Creditors	1,20,000	80,000	Other current assets	2,25,000	1,28,000
	11,60,000	4,05,000		11,60,000	4,05,000

Draw a consolidated Balance Sheet as at 31st March 1996 after taking into consideration the following information.

i. H Ltd. acquired the shares on 31st July 1995.

ii. S Ltd earned profit of Rs.45, 000 for the year ended 31st March 1996.

iii. In January 1996 S Ltd. sold to P Ltd goods costing Rs.15,000 for Rs.20,000 On 31st March 1996 half of these goods were lying as unsold in the godown of H Ltd.

NOTES

Consolidated Balance sheet of H Ltd and its subsidiary S Ltd as on 31.3.1996

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
Share Capital		8,00,000			
General reserve		1,50,000	Goodwill		58,750
Profit & Loss A/c	90,000		Fixed Assets		
Add. 'H' Ltd.'s shares of revenue profit	22,500		H Ltd	5,50,000	
			S Ltd	1,00,000	6,50,000
	----------		Stock		
	1,12,500		H Ltd	1,05,000	
Less::			S Ltd	1,77,000	
Provision for		----------		----------	
Unrealized profit	2,500	1,10,000		2,82,000	
		----------	Less: Provision	2,500	
Creditors			Unrealized profit	----------	2,80,000
H Ltd	1,20,000				
S Ltd	80,000	2,00,000			
			Other current		
Minority Interest		81,250	Assets:		
			H Ltd	2,25,000	
			S Ltd	1,28,000	3,53,000
		----------			----------
		13,41,250			13,41,250
		----------			----------

NOTE

Working Notes:

1. Holding minority ratio

H Ltd acquired 75% of share in S Ltd

Minority holding in S Ltd = 25%

Ratio = 75: 25 or 3: 1

2. Revenue Profits

		Rs.
Current year profit of S Ltd given		45,000
Profit earned by S Ltd after 31st July or		
Revenue profit	$= 45,000 \times 8/12$	30,000
Holding company's share	$= 30,000 \times \frac{3}{4}$	22,500

NOTES

Minority share $= 30{,}000 \times \frac{1}{4}$ 7,500

3. Capital Profits

	Rs.
General Reserve of S Ltd 31.3.96	70,000
Profit & Loss Account of S Ltd 31.3.96	55,000
	1, 25,000
Less Revenue Profit	30,000
Capital Profit	95,000

Holding company's share $= 95{,}000 \times \frac{3}{4} = 71{,}250$

Minority's share $= 95{,}000 \times \frac{1}{4} = 23{,}750$

NOTES

4. Minority Interest

Face value of minority shares 2, 00,000 x $\frac{25}{100}$ = Rs.50, 000

Add: Minority share of capital profit	23,750
Add: Minority share of revenue profit	7,500
Minority interest	81,250

5. Cost of control or good will Rs.

Amount paid for shares purchased by H Ltd in S Ltd 2,80,000

Less Face value of shares purchased 2,00,000 x $\frac{3}{4}$ = 1,50,000

NOTES

Less	Holding company's shares of capital profits	= 71,250	
		---------	2, 21,250

	Good will		58,750

6. Provision for unrealized profit in stock

Profit in stock of H Ltd acquired from S Ltd.

$$(20{,}000 - 15{,}000) \times \frac{1}{2} = 5{,}000 \times \frac{1}{2} = 2{,}500$$

Provision to be created = 2,500

Illustration – 3

From the following Balance Sheet relating to H Ltd and S Ltd. prepare a consolidated Balance Sheet.:

Liabilities	H Ltd Rs.	S Ltd Rs.	Assets	H Ltd Rs.	S Ltd Rs.
			Sundry		
Share Capital			Fixed assets	8,00,000	1,20,000
(Shares of Rs.10	10,00,000	2,00,000	Stock	6,10,000	2,40,000
each)	4,00,000	1,20,000	Debtors	1,30,000	1,70,000
Profit & Loss A/c	1,00,000	60,000	Bills	10,000	----
Reserves	2,00,000	1,20,000	Payable		
Creditors	-------	30,000	Shares in 'S	1,50,000	
Bills payable			Ltd at cost		
	-----------	-----------	(15,000	-----------	-----------
	17,00,000	5,30,000	shares)	17,00,000	5,30,000
	-----------	-----------		-----------	-----------

a. All profits of S Ltd have been earned after the shares were acquired by H Ltd. But there was already a reserve of Rs.60, 000/- on that dated.
b. All the bills payable of S Ltd was accepted in favor of H Ltd.
c. The Stock of H Ltd. includes Rs.50, 000/- purchased from S Ltd. The profit added was 25% on cost.

NOTES

Consolidated Balance sheet of H Ltd and its subsidiary S Ltd as on 31.12.1992

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
Share Capital			Sundry Assets		
1,00,000shares of			H Ltd	8,00.000	
Rs.10 each		10,00,000	S Ltd	1,20,000	
General reserve				----------	9,20,000
			Stock	-	
Profit & Loss A/c	4,00,000		H Ltd		
Add. 'H' Ltd.'s			S Ltd	6,10,000	
shares of revenue	90,000			2,40,000	
profit	----------			----------	
	4,90,000		Less: Provision	-	
				8,50,000	8,40,000
Less::				10,000	
Provision for	10,000	4,80,000	Debtors	----------	
Unrealized profit			H Ltd	-	
		1,00,000	S Ltd		
Reserve		45,000			3,00,000
Capital reserve			Bills	1,30,000	
Creditors	2,00,000		receivable	1,70,000	
H Ltd	1,20,000	3,20,000	Less Mutual	----------	------
S Ltd	----------		obligation	-	
	30,000			10,000	
Bills payable	10,000	20,000		10,000	
Less Mutual	----------			----------	
obligation	-	95,000		-	
Minority Interest		----------			----------
		20,60,000			20,60,000
		----------			----------

NOTES

Working Notes:

1. Holding minority ratio

Total shares in S Ltd	$\frac{2,00,000}{10}$	20,000
Shares required by H Ltd in S Ltd.		15,000
Minority Shares		5,000

Ratio = 15,000: 5,000 = 3: 1

2. Capital Profits

		Rs.
Reserve of S Ltd on the date of purchase of shares in S Ltd by H Ltd		60,000
Capital Profit	= Rs.60,000	
Holding company's shares	= Rs.60,000 x $\frac{3}{4}$ =	45,000
Minority's shares	= Rs.60,000 x $\frac{1}{4}$ =	15,000

NOTES

3. Revenue Profits Rs.

Profit earned by S Ltd after shares were acquired by H Ltd in S Ltd	= P/L A/c	1,20,000

Revenue Profit = Rs.1,20,000

Holding company's shares $= \text{Rs.}1{,}20{,}000 \times \dfrac{3}{4} =$ 90,000

Minority's shares $= \text{Rs.}1{,}20{,}000 \times \dfrac{1}{4} =$ 30,000

NOTES

4. Minority Interest

Face value of minority shares 5,000 x	10 =		50,000
Add: Minority share of capital profit	=		15,000
Add: Minority share of revenue profit	=		30,000

Minority interest			95,000

5. Cost of control or good will

		Rs.
Amount paid for shares purchased by H Ltd in S Ltd		1, 50,000
Less Facc value of shares purchased 15,000 x 10=1, 50,000		
Holding company's shares of capital profits =	45,000	1, 95,000

Capital Share		45,000

NOTES

6. Provision for unrealized profit in stock

Stock with H Ltd purchased from S Ltd.

Profit included in Stock 25% on cost

or 20% on sale price = $\dfrac{50,000 \times 20}{100}$ = 10,000

Provision to be made = 10,000

Illustration – 4

The following are the Balance Sheets of H Ltd and its subsidiary S Ltd. as on 31.3.1995

Liabilities	H Ltd Rs.	S Ltd Rs.	Assets	H Ltd Rs.	S Ltd Rs.
Share Capital Rs.10 each full paid	6,00,000	2,00,000	Machinery	3,00,000	1,00,000
General Reserve	1,50,000	70,000	furniture	70,000	45,000
Profit & Loss A/c	70,000	50,000	70% shares in S Ltd at cost	2,60,000	----
Creditors	90,000	60,000	Stock	1,75,000	1,89,000
			Debtors	55,000	30,000
			Cash at Bank	50,000	10,000
			Preliminary expenses	---------	6,000
	9,10,000	3,80,000		9,10,000	3,80,000

H Ltd acquired the shares of S Ltd on 30th June 1994. On 1st April 94, S Ltd's general reserve and profit & loss account stood at Rs.60,000 and 20,000 respectively. No part of the preliminary expenses was written off in the year ended 31.3.95

Prepare consolidated Balance Sheet of H Ltd and its subsidiary S Ltd as on 31.3.95 giving all your working notes separately.

NOTES

Consolidated Balance sheet of H Ltd and its subsidiary S Ltd as on 31.3.1995

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
Share Capital			Good will		61,200
60,000shares of			Machinery		
Rs.10 each		6,00,000	H Ltd	3,00.000	
General reserve		1,50,000	S Ltd	1,00,000	
				-----------	4,00,000
Profit & Loss A/c	70,000		Furniture		
Add. 'H' Ltd.'s			H Ltd	70,000	
shares of revenue	21,000		S Ltd	45,000	
profit	---------	94,000		-----------	1,15,000
	--		Stock		
Creditors			H Ltd	1,75,000	
H Ltd	90,000		S Ltd	1,89,000	3,64,000
S Ltd	60,000	1,50,000		-----------	
	---------		Debtors		
	---	94,200	H Ltd	55,000	
Minority Interest			S Ltd	30,000	
				-----------	85,000
			Cash at Bank		
			H Ltd	50,000	
			S Ltd	10,000	
				-----------	60,000
		-------------			-----------
		10,85,200			10,85,200
		-------------			-----------

NOTES

Working Notes

1. **Holding minority ratio**

Holding company acquired 70% of the share

Is subsidiary

Minority stake in the share capital is 30%

Holding Minority ration = 70: 30 = 7: 3

2. Revenue Profits	Rs.
General Reserve of S Ltd on 31.3.95	70,000
Profit & Loss A/c of S Ltd on 31.3.95	50,000
	1, 20,000
Less	
Accumulated profits of S Ltd on 1.4.94	
(60,000 + 20,000)	80,000
Profit earned during 1994 – 1995	40,000
Profit earned after 30th June	
or Revenue Profit = Rs.40,000 x 9 ------=	30,000

NOTES

12

Holding Company share = Rs.30,000 x 7
-------= 21,000
10

Minority Share = Rs.30,000 x 3
-------= 9,000
10

3. Capital Profits

General Reserve on 1.4.1994 60,000

Profit & Loss account on 1.4.1994 20,000

Current year profit before 30.6.94 = 40,000 x 3
------- = 10,000
12

90,000

Less: Preliminary expenses 6,000

Capital profits 84,000

Holding company's share = 84,000 x 7
----- = 58,000
12

Minority shares $= 84{,}000 \times \frac{3}{10} = 25{,}200$

4. Minority Interest

Face value of minority shares $2{,}00{,}000 \times \frac{3}{10}$ =	60,000
Add: Minority share of capital profit =	25,200
Add: Minority share of revenue profit =	9,000
Minority interest	94,200

5. Cost of control or goodwill

		Rs.
Amount paid by H Ltd for shares purchased in S Ltd		2, 60,000
Less Face value of shares purchased $2{,}00{,}000 \times \frac{70}{100}$ =1, 40,000		
Holding company's shares of capital profits =	58,800	1, 98,000
Good will (to be shown in Balance Sheet		61,200

LESSON-15

INSURANCE ACCOUNTS

NOTES

Insurance is a contract in which one party known as the insurer undertakes to indemnity the loss suffered by the other party known as insured. In consideration for a fixed sum of money known as premium. The insurer collects the money from all those who want to have protection against unforeseen events. The insurer pays a sum equivalent to the loss or to that extent of loss given in the contract, to those who really suffer a loss, and loose only the premium paid. The document containing the terms of insurance contract is known as the policy.

Meaning of Insurance:

Promise of reimbursement in the case of loss; paid to people or companies so concerned about hazards that they have made prepayments to an insurance company

There are various types of insurance business such as Life insurance, Fire insurance, Marine Insurance, Burglary insurance, Fidelity insurance, (Dishonesty of employees), Accident insurance etc. Except the life insurance business, all other insurance are included in General insurance business. The life insurance business and general insurance business nationalized in the years 1956 and 1971 respectively.

LIFE INSURANCE

A public corporation was set up by the government in 1956 to carry on the life insurance business in India. The nature of Life insurance business differs from that of General insurance business. The life insurance contracts are for a long term and therefore before ascertaining the profit in this business, the future implications of the contract are to be considered.

ANNUITY

It is a kind of life insurance business wherein the insurance office receives a lump sum money from a person and agencies to pay a sum of money periodically at regular intervals as long as the lives. This person is called "Annuitant" in an annuity contract. The amount payable in lump sum in the beginning determine by taking into consideration the age of the person and the prevailing rate of interest. This lump sum is referred to as "consideration the age of the person and the prevailing rate of

NOTES

interest. This lump sum is referred to as "consideration for annuities granted" and is an income to the life insurance corporation. The annual or regular payment is called "Annuity" and is an expense.

What is surrender?

Acceptance of despair

SURRENDER

When a policy holder discontinued his/her premium payment and surrenders a policy, he / she get a certain sum from the Life insurance Corporation known as "surrender Value". It is the present cash value of the policy. It is calculated at some specified rate amount paid as surrender value is an expense of the life insurance business.

POLICY AND ITS KNIDS

Policy is a document containing the terms of an insurance contract.

WHOLE LIFE POLICY AND ENDOWNMENT POLICY

Whole life policy matures only on the death of the insured whereas Endowment policy matures on the policy holder reaching a certain age or on his death whichever is earlier.

What does the meaning of bonus?

An additional payment (or other remuneration) to employees as a means of increasing output

BONUS

It is share of profit which a policy holder gets from the Life insurance corporation. "Reversionary Bonus"., is that which is paid only on the maturity of the policy but "Bonus in cash, is paid immediately. "Bonus in reduction of premium" is not paid in cash but is adjusted against the future premiums due from the policy holders. Interim bonus, like interim dividend, refers to bonus declared for a period for which the profit has not yet been ascertained.

ASSIGNMENT

Assignment of a policy is allowed and this is done either by making an endorsement by or a separate instrument. The assignee can sue in his own name. On

receipt of an assignment notice by the insurer, a certificate of acknowledgement is issued.

Among others the principal books maintained in life assurance companies are:

PROPOSAL REGISTER

On receipt of proposal from the insured details such as proposer's name, proposal number, agency, class, amount etc., are recorded in this register. The decision on the proposal by the management is recorded in the "Remarks" column.

NEW PREMIUMS AND ITS CASH REGISTER

The growth of the insurance company is usually viewed by the amount of the new business it secures each year. As such the amount of new premium received each year is recorded separately from the Renewal premiums. The insurance act requires that the first year's premium should be shown distinctly from the renewals in the Revenue Account. The details such as the name of the assured number, date and class of the policy sum assured, the agent, annual premium amount and term of its payment folio of the policy holders Register are recorded in new premiums cash register and the daily total of this register is entered in the General cash book in the New premiums column from where the monthly total is posted to the New premiums Accounts in the general ledger.

RENEWAL PREMIUM CASH REGISTER

The details of renewal premiums received are entered in this register and the daily total is entered in the General cash book in the Renewal premiums column and the monthly total of this column is posted to the credit of Renewal premium Account in the General Ledger.

AGENCY AND BRANCH CASH BOOK

The sums received from each branch or agency is recorded under the respective columns of each branch or agency in this book. The daily total of this book is entered in the general cash book under the column headed as "Branch and Agency

NOTES

Remittances" and the monthly total of this column i.e., the Branch and agency remittances column of the general cash book is posted to the credit in the agency and branch cash book is posted to the credit of the particular branch or agency account in the Agency Ledger.

CLAIMS CASH BOOK

The details of claims paid are recorded in this book and the daily total of this book is shown under the "claims paid" column in the General cash book. The monthly total is posted to the debit of claims account in the general ledger.

GENERAL CASH BOOKS

In order to save labor in posting, the usual heads of receipt and expenditure are provided with separate columns in this book. On the debit side of the general cash book separate columns are provided for New and Renewal premiums, remittance from branches and agencies, loans on policies, repaid, investment realized, interest on investment and loans, considerations for annuities granted and miscellaneous receipts. Similarly, on the credit side of this book separate columns are provided for claims. Annuities surrenders, Reassurances, Bonuses, policy-loans, investments, management expenses and sundry payments. The monthly total as appearing under various columns is posted to their respective accounts in the General Ledger.

PETTY CASH BOOK

The petty cash book is usually kept under imp rest system with various analytical columns for recording expenses like Medical fees commission, policy stamps, Advertisements, printing and stationery postage etc.

AGENTS AND JOURNALS

Generally a great part of the assurance business (new) is done by the agents who are scattered all over the country. Their remuneration is paid in the form of

NOTES

commission on the business secured. Larger percentage of commission is allowed on new business canvassed by the agents and only a lower percentage is allowed on renewals.

Agencies Debit journal is a record in which all premiums and other sums which have to be collected by the agents and branches are entered by debiting the individual agent or branch account. The monthly total of the "Total Column" of this book is debited to the "Branches and agencies account" in the general.

Agency credit journal is a record in which the details of the statements sent by each branch or agency to the Head office are recorded. The individual agent or branch account is credited in the agency ledger with the details appearing in this journal. The monthly total of the total column of the book is posted to the credit of the "Branches and Agencies Accounts" in the General ledger.

COMMISSION BOOK

The purpose of this book is to show the amount of commission due to each agent on every policy secured by him, as well to show against this the several payments made to him or deducted by him from the premiums collected. Thus, the book enables the company to understand the position of each agent in respect of his commission account and also in arriving at the commission outstanding due at the time of balancing of accounts. Each account in this book will also exhibit the terms of commission, travelling office or any other allowance etc., which have been agreed upon between the agents and the company.

NOTES

Illustration.1

The following balances are abstracted from the books of New Bharat Life Insurance Co. Ltd.,

as on 31.3.2006.

	Rs.('000)		Rs.('000)
Life Assurance Fund (1-4-2005)	15,00,000	Claims paid during the	64,900
Premiums	4,96,000	year	2,050
Consideration for annuities	15,000	Annuities	1,600
granted	1,00,000	Bonus in reduction of	2,400
Interest & Dividends	750	premiums	4,000
Fines for revival of policies	20,750	Medical fees	18,650
Re insurance premium	4,500	Surrenders	22,000
Claims outstanding(1.4.2005)		Commission	8,500
		Management expenses	
		Income tax on Dividends	

Prepare Revenue A/c after making the following adjustments:

	Rs. ('000)
(I) Outstanding Balances	
Claims	14,000
Premiums	4,600
(II) Further bonus for premium	2,400
(III) Claim under reinsurance	8,000

NOTES

NEW BHARATH LIFE ASSURANCE CO., LTD.,

Revenue Account for the year ended 31st March 2006

Particulars	Schedule No.	Current Year (Rs '000)	Previous year (Rs. '000)
Premiums Earned – Net			
(a) Premium	1	5,03,000	-
(b) Reinsurance ceded		(-)20,750	-
(c) Reinsurance accepted		-	-
Income from Investments:			
(a) Interest and Dividends (Gross)		1,00,000	-
Other Income (To be specified)			
Consideration for annuities granted		15,000	-
Fines for revival policies		750	-
Total (A)		5,98,000	-
Commission	2	18,650	
Operating expenses related to Insurance business	3	24,400	
Total (B)		43,050	
Benefits Paid(Net)	4	76,450	
		76,450	
Surplus (D) = (A)-(B)-(C)		4,78,500	

Note: Income tax on dividends is a TDS and will appear in schedule 12 under advances and other assets, as per the IRDA form.

NOTES

Schedules Forming Part of Revenue Account

Schedule 1 – Premium

No.	Particulars	Current year (Rs. '000)	Previous year (Rs. '000)
	Premiums received	4,96,000	-
	Add: Outstanding premiums	4,600	-
	Add: Further bonus in reduction of premium	2,400	-
		5,03,000	-

Schedule 2 – Commission expenses

No.	Particulars	Current year (Rs. '000)	Previous year (Rs. '000)
	Commission paid	18,650	-
		18,650	-

Schedule 3 – Operating expenses related to Insurance Business

No.	Particulars	Current year (Rs. '000)	Previous year (Rs. '000)
	Management expenses	22,000	-
	Medical fees	2,400	-
		24,400	-

Schedule 4 – Benefits paid (Net)

No.	Particulars	Current year (Rs. '000)	Previous year (Rs. '000)
	Claims paid	64,900	-
	Add: Outstanding claims on 31-3-06	14,000	-
		78,900	-
	Less: Outstanding claims on 1-4-05	4,500	-
		74,400	-
	Less: Claims under reinsurance	8,000	-
		66,400	-
	Annuities	2,050	-
	Surrenders	4,000	-
	Bonus in reduction of premium (1600+2400)	4,000	-
		76,450	-

Illustration-3

From the following balances extracted from the books of the L.I.C as at 31.3.06, prepare a Revenue A/c for the year ending 31.3.2006 in the prescribed form:

	Rs. (in '000)		Rs. (in '000)
Claims by death	3,30,000	Life Assurance fund(1.4.05)	63,31,000
Claims by maturity	2,15,000	Premiums	20,65,000
Agents & Canvasser's	26,500	Bonus in reduction of premiums	1,000
allowance	44,200	Income tax on interest and	5,700
Salaries	1,200	dividends	13,900
Travelling expenses	8,700	Printing & Stationery	14,300
Directors' fees	1,000	Postage & telegrams	2,300
Auditor's fees	52,000	Receipt stamps	40,950
Medical fees	2,18,000	Reinsurance premiums	2,72,000
Commission	2,800	Interest & dividend (gross)	9,600
Rent	200	Policy renewal fees	540
Law charges	4,300	Assignment fees	690
Advertising	1,500	Endowment fees	1,400
Bank charges	2,000	Transfer fees	
General charges	47,500		
Surrenders			

Provided Rs.1, 500 thousands for depreciation of furniture and Rs.2, 20,000 thousands for depreciation on investments

NOTES

Solution

Revenue Account of Life Insurance Corporation

For the year ended 31st March 2006

Particulars	Schedule No.	Current year (Rs. '000)	Previous year (Rs. '000)
Premiums earned- Net:			
(a) Premium	1	20,65,000	-
(b) Reinsurance ceded		(-)40,950	-
(c) Reinsurance accepted		-	-
Income from Investments:			
(a) Interest dividends and Rents		2,72,000	-
Other Income (To be specified):			
Policy renewal fees		9,600	-
Assignment fees		540	-
Endowment fees		690	-
Transfer fees		1,400	-
Total (A)		23,08,280	-
Commission	2	2,18,000	-
Operating expenses related to Insurance business	3	1,76,400	-
Depreciation in the value of Investments		2,20,000	-
Total (B)		6,14,400	-
Benefits paid (Net)	4	5,93,500	-
		5,93,500	-
Total (C)		11,00,380	-
Surplus (D) = (A)-(B)-(C)			

Note: Income tax on interest and dividends is a TDS and will appear in schedule 12... advances and other assets as per IRDA form.

NOTES

Schedules Forming part of Revenue Account

Schedule 1 – Premium

No	Particulars	Current year (Rs. '000)	Previous year (Rs. '000)
	Premiums received	20,65,000	-
		20,65,000	-

Schedule 2 – Commission Expenses

No.	Particulars	Current year (Rs. '000)	Previous year (Rs. '000)
	Commission paid	2,18,000	-
		2,18,000	-

Schedule 3 – Operating expenses related to Insurance Business

No.	Particulars	Current year (Rs. '000)	Previous year (Rs. '000)
	Agents & Canvasser's Allowance	26,500	-
	Salaries	44,200	-
	Travelling expenses	1,200	-
	Directors fees	8,700	-
	Auditors fees	1,000	-
	Medical fees	52,000	-
	Rent	2,800	-
	Law charges	200	-
	Advertising	4,300	-
	Bank charges	1,500	-
	General charges	2,000	-
	Printing and Stationery	13,900	-
	Postage and Stationery	14,300	-
	Receipt Stamps	2,300	-
	Depreciation on furniture	1,500	-
		1,76,400	-

NOTES

Schedule 4 – Benefits paid (Net)

No.	Particulars	Current year (Rs. '000)	Previous year (Rs. '000)
	Claims paid:		
	By death	3,30,000	-
	By Maturity	2,15,000	-
	Surrenders	47,500	-
	Bonus in reduction of Premiums	1,000	-
		5,93,500	-

Illustration-4

Prepare the following a Life Insurance revenue A/c and Balance Sheet as on 31.3.2006.

	Rs. ('000)		Rs. ('000)
Claims by death	16,890	Outstanding interest on Advances (31.3.2006)	1,944
Agent's salaries & allowances	6,420	Bonus paid with claims	2,700
Surrender values paid	2,810	Endowment assurance matured	24,415
Actuarial expenses	1,520	Annuities paid	1,350
Premiums	94,836	Interest revenue	19,060
Commission to Agents	8,900	Rent, Rates, & Taxes	5,475
Salaries	13,500	General charges	1,860
Medical fees	1,200	Fees received	172
Travelling expenses	1,800	Bonus paid in cash	2,825
Director's fees	900	Advertisement	726
Agents balances	750	Consideration for annuities granted	12,853
Claim expenses	1,432	Printing & Stationery	650
Premium outstanding(1.4.2005)	2,134	Claims O/S(1.4.05)	2,376
Premium	3,143	Claims O/S(31.3.06)	3,735
outstanding(31.3.2006)	1,46,700	Loans on policies	38,300
Investments	2,00,000	Loans on mortgages	2,90,560
Share capital	9,200	Freehold premises	1,22,600
Sundry creditors	3,53,672	Furniture & fittings	64,100
Life Assurance Fund(1.4.05)	1,46,000	Cash on hand & deposits	76,300
Reserve fund			

NOTES

Solution

Revenue Account for the year ended 31-3-2006

Particulars	Schedule No.	Current year (Rs. '000)	Previous year (Rs. '000)
Premiums earned – Net:	1	92,702	-
Interest revenue		19,060	-
Other Incomes (To Be specified):			
Consideration for annuities granted		12,853	-
Fees received		172	-
Total (A)		1,24,787	-
Commission	2	8,900	-
Operating expenses related to Insurance Business	3	34,051	-
Total (B)		42,951	-
Benefits paid (Net):	4	50,046	-
Total (C)		50,046	-
Surplus (D) = (A)-(B)-(C)		31,790	-
Appropriations:			-
Transfer to shareholders account			-
Transfer to other reserves		31,790	-
Balance being funds for future appropriations		31,790	-
Total (D)			

NOTES

Balance Sheet as on 31-3-2006

Particulars	Schedule No.	Current year (Rs. '000)	Previous year (Rs. '000)
Sources of Funds:			
Share capital	5	2,00,000	-
Reserves and surplus	6	5,31,462	-
Borrowings	7	-	-
		7,31,462	-
Total			
Application of Funds:	8	1,46,700	-
Investments	9	3,28,860	-
Loans	10	1,86,700	-
Fixed Assets		6,62,260	-
Total	11	76,300	
Current Assets:	12	5,837	
Cash and Bank balances		82,137	
Advances and other assets	13	12,935	
Sub Total (A)	14	-	
Current liabilities		12,935	
Provisions		69,202	
Sub Total (B)		7,31,462	
Net Current assets(A-B)			
Total			
(total of schedules 8,9,10 and Net Current assets)			

NOTES

LESSON-16

ACCOUNTS OF ELECTRICITY COMPANIES

Electricity companies are controlled by Government since they are public utility undertakings. This business is subject to the Indian Electricity Act. 1910 and The Electricity (supply) Act. 1948. The published account should be drawn as per the provisions of the Companies Act, 1956 but the financial provisions of the Electricity (Supply) Act, 1948 should be complied with. The accounting year of the company must end on 31st March. The fixed assets are grouped under the following headings.

1) Land
2) Buildings
3) Plant-Steam, Diesel and Miscellaneous
4) Distribution Mains-Overhead, underground
5) Services
6) Meters
7) Street Lighting
8) Furniture and Equipment and
9) Motor Vehicles.

The financial provisions of Electricity (Supply) Act, 1948 are as follows:

NOTES

Reasonable Return

The act prevents an electricity company to earn a very high profit. So a 'reasonable return' consists of the following:

1. An amount calculated at Reserve Bank rate plus two percent on 'capital base'.
2. Income from investments except income from investments made against contingency Reserve.
3. An amount at the rate of ½% on the balance of Development Reserve.

The 'Capital Base' can be calculated as follows

	Rs.		Rs.
1. Provision for depreciation 2. Amount written off for intangible assets 3. Loans advanced by Electricity Board 4. Security Deposits of customers held in cash 5. Development Reserve 6. Tariffs and Dividend control Reserve 7. Amount carried forward for distribution to consumers Capital base balancing figure		1. Original cost of fixed assets available less contribution by consumers 2. Cost of intangible assets 3. Original cost of works in Progress 4. Compulsory investments against contingency Reserve 5. Working capital being average of stores, materials cash and Bank balances	

CLEAR PROFIT: It means the difference between the total income and the total expenditure plus specific appropriations. This may be calculated as follows:

REVENUE

Sale of energy
Meter Rents
Sale and Repairs of Lamps etc.,
Rents, less outgoings
Transfer fees
Interest from investments etc.,
Other Receipts ----------

Less: Operating Expenses:

Cost of generation and purchase
Distribution and Selling expenses
Rent, Rates and Taxes (excluding taxes on income or profits)
Interest on loans by electricity board
Interest on security deposit
Bad debts
Audit fees
Management expenses
Depreciation
Other admissible expenses
Contribution to P.F., gratuity etc.
Bonus to employees in accordance with the decision of labor tribunal
----

Less: Special Appropriations

Previous losses
Taxes on income and profit
Written off of intangible assets
Contribution of Contingency Reserve
Arrears of Depreciation
Development Reserve
Appropriations permitted by State Government

Clear Profit

NOTES

What is clear profit?

It means the difference between the total income and the total expenditure plus specific appropriations.

NOTES

DISPOSAL OF SURPLUS

The excess of clear profit over 'reasonable return' is available at the disposal of the undertaking to the extent of one third not exceeding 5% of the reasonable return. Of the balance, one-half will be transferred to 'Tariffs' and Dividend Control Reserve and the balance will be transferred to Consumers Rebate Reserve for Special rebate or for reduction of rates.

The excess of clear profit over reasonable return in any year should not exceed 15% of reasonable return. If it falls short of reasonable return, the Tariffs and Dividend control Reserve may be used for dividend etc.

DEVELOPMENT RESERVE

An amount equal to Income Tax and Super Tax payable but for the Development Reserve allowed is to be transferred to Development Reserve Account.

In any accounting year if the clear profit without considering special appropriation plus the balance in Tariffs and dividends control Reserve falls short of required reserve, the shortage need not be made good.

GENERAL RESERVE

After providing for interest and depreciation, a contribution to general reserve shall be made at the rate of ½% of the original cost of the fixed asset till the total of such reserve equal 8% of the original cost of the assets

CONTINGENCY RESERVE

The balance in this account should not exceed 5%of the original cost of fixed assets. The annual contribution from Revenue Account to this Account shall be equal to not less than ¼% and not more than ½% original cost of fixed assets until it reaches maximum amount. Loss or sale of fixed asset is also transferred to this account. This reserve must be invested in trust securities. This ear be utilized to meet expense or losses arising out of accidents or fortuitous circumstances: to meet expenses of replacement or removal of plant and to pay compensation under statutory obligation, if here is no provision for such compensation.

DEPRECIATION

Under section 63 of Electricity (Supply) Act, 1948, every year interest at the rate of 4% on the opening balance of Depreciation Reserve Account must be transferred from Revenue Account to Depreciation Reserve Account.

In Schedule VI two systems of depreciation viz. Straight line method and Compound Interest Method are provided. In Straight Line method 90% of cost is to be written off over the life. In compound Interest method an amount which together with 4% interest per an num amount to 90% of cost is to be provided within the life of the asset. No depreciation is to be provided when 90% has been written off or when the asset is not used due to obsolescence.

SPECIMEN STATEMENTS

STATEMENT I

Statement of Share and Loan Capital for the year ended 31st March….

Description of Capital 1	Balance at the beginning Of years Rs. 2	Receipts during the year Rs. 3	Redeemed during the year Rs. 4	Balance at the end of the year Rs. 5	Remarks 6
A. Share Capital Authorized Capital Issued Capital subscribed Capital Called up capital Total Paid up Capital **B. Capital Revenue** C. Loan Capital **D.Other Capital** Contributions from consumers including local authorities for service lines, public lighting.					

TOTAL CAPITAL RAISED

STATEMENT II

Statement of Capital Expenditure for the year ended 31st March........

Particulars 1	Balance at the beginning of the year Rs. 2	Additions during the year Rs. 3	Retirements during the year Rs. 4	Balance at the end of the year Rs. 5	Remarks 6
A - Intangible Assets B- Hydraulic Power Plant C-Steam Power Plant D- Interest Combustion Power Plant E- Transmission Plant – high F- Distribution Plant (high voltage) G- Distribution Plant (Medium Low Voltage) M- Public Lighting I – General Equipment Total Capital					

NOTES

STATEMENT III

Statement of Operating Revenue for the year ended 31st March....

Particulars of Revenue	Corresponding amount for the previous year Rs. 2.	Amount for the year of account Rs. 3	Remarks 4
Net Revenue by Sale of electricity for cash and credit. Domestic and Residential Commercial Industrial Public Lighting Public Water Works & Sewage Pumping Irrigation Tractions Supplies in Bulk Miscellaneous Revenue from customers Rentals from meters and Re, connection fees Other Revenues Total Operating Revenues Deduct Total Operating Expenses Net Surplus Carried to Net Revenue and Appropriation A/c			

STATEMENT IV

Statement of Operating Expenses for the Year ended……

Particulars of Expenses	Corresponding amounts For the previous year of account Rs. 2	Amount for the year of a account Rs. 3	Remarks 4
A- Hydraulic Power Generation			
B- Steam Power Generation			
C- Internal Combustion Power generation			
D- Power purchased Total production expenses			
E- Transmission (High or extra high voltage)			
F- Distribution High Voltage			
G- Distribution Medium or Low voltage depreciation total distributions			
H- Public Lighting consumer's servicing, Meter Reading, Billing, Connecting, Accounting, Sales promoting, Etc.			
I- General Establishment charges: other charges management expenses			
Total operating Expenses			
Transferred to Statement III			

NOTES

ILLUSTRATION: 1

Madurai Electric Ltd earned a Profit of Rs.26, 90,000 during the year ended 31st March 1984 after debenture interest @ 7 ½% on Rs.5, 00,000 with the help of figures given below. Show the disposal of the profits:

	Rs.
Original cost of Fixed assets	2,00,000
Total depreciation Written off	40,00,000
Loan from Electricity Board	30,00,000
Reserve Fund(Investments in 4% Government Securities)	20,00,000
Contingencies Reserve Fund Investments	5,00,000
Tariff and dividends control Reserve	1,00,000
Security deposit of customers	4,00,000
Preliminary expenses	10,00,000
Monthly average of current assets(net)	50,00,000

Assume Bank rate at 10%.

NOTES

Solution:

Calculation of Capital Base

	Rs.	Rs.
Original cost of fixed assets		20,00,000
Preliminary expenses		10,00,000
Monthly average of current assets		50,00,000
Contingencies Reserve Fund Investments		5,00,000
		2,65,000
Less: Depreciation of Fixed assets	40,00,000	
Loan from Electricity Board	30,00,000	
Debentures	5,00,000	
Security deposit of customers	4,00,000	
Tariff and Dividend control Reserve	1,00,000	
		80,000
		1,85,000

Reasonable Return:

12% of capital base Rs. 1, 85, 00,000	22, 20,000
½% on Loan from Electricity Board is Rs. 30, 00,000	15,000
½% on Debentures is Rs. 5, 00,000	2,500
Income from Reserve Fund Investment @ 4% on Rs. 20, 00,000	80,000
	23, 17,500

Surplus = Rs. 26, 90,000 – 23, 17,000 = Rs. 3, 73,000

1/3 of Surplus = Rs. 1, 24,333

5% of Reasonable Return = Rs. 1, 15,875

Disposal:

1/3 for the company not exceeding 5% of reasonable Return	1, 15,875
Tariffs and dividends control Reserve	1, 28,562-50
Customers special rebate	1, 28,562-50
	3, 73,000

NOTES

Exercise

1. Gopal Electricity Co earned a Profit of Rs.33, 97,000 after paying Rs.1, 20, 000 @ 6% as debenture interest for the year ended 31.3.2004. the following further information is supplied to you:

	Rs.
Fixed assets	7,20,00,000
Depreciation written off	2,00,00,000
Loan from Electricity Board	1,60,00,000
Reserve Fund Investment at part (4%)	40,00,000
contingency Reserve Investment at par(4%)	30,00,000
Tariffs and dividend Control Reserve	4,00,000
Security deposits of Customers	6,00,000
Customer's contribution to assets	2,00,000
Preliminary expenses	1,60,000
Monthly average of current assets including amount due from customers Rs.10,00,000	30,40,000
Development Reserve	10,00,000

Show the disposal of the profits.

2. From the following information and details relating to the year ended 31.3.80 and bearing in mind the provisions of the Electricity (supply) Act 1948 indicate the disposal of profits of X Electricity Corporation Ltd:

	Rs.
Net profit before charging debenture interest	35,00,100
Fixed Assets	4,20,00,000
Depreciation written off on fixed assets	98,00,000
Loan from Electricity Board	1,20,00,000
6% Investments of the Reserve Fund [F.V. Rs.90,00,000]	90,00,000
6% Investments of the contingencies Reserve	76,00,000
Tariffs and Dividends Control Reserve	8,40,000
Security Deposits of customers	4,84,000
Customers contribution to main lines	3,20,000
Preliminary Expenses	1,40,000
Average of current assets – excluding customers balance of	23,70,000
Rs. 6,20,000	4,40,000
Development Reserve	7,50,000
10% Debenture Interest Paid in the year	

The RBI rate on the relevant date was 8%.

NOTES

NOTES

3. Saharanpur Electricity Co.Ltd. earned a profit of Rs.17, 40,000 during the year ended 31.3.2004 after charging interest on debentures amounting to Rs. 45,000 @ 7 ½%. You are required to show the disposal of profit assuming bank rate at 6% with the help of the following data:

	Rs.
Fixed assets at cost	2,50,00,000
Preliminary expenses	5,00,000
Monthly average of current assets including amount due to customers Rs.6,00,000	36,00,000
Reserve Fund(represented by 6% Govt. securities)	40,00,000
Total Depreciation written off	77,00,000
Contingencies Reserve Investments	10,00,000
Loan from Electricity Board	50,00,000
Tariff and Dividend control reserve	2,00,000
Security deposits received from customers	5,00,000
Development reserve	5,00,000

LESSON-17

NOTES

DOUBLE ACCOUNT SYSTEM

Double account system is not a separate system of according. It is merely a way of presentation of final accounts of certain companies, usually of public utilities. Therefore, up to the preparation of Trial Balance practically there is no difference at all between the double account system and the ordinary system of accounting. While preparing the revenue accounts and the Balance Sheet, we distinguish the double accounts in the following manner:

1. The Balance Sheet is split into two parts. The first part is prepared as an account and it contains accounting information of all fixed assets and fixed liabilities. On both Dr. and Cr. Sides of these accounts we have to provide three columns for amount-first column shows the relevant figures up to the end of the previous year, second column shows the figures for the current year and the third column shows the total of the two columns. This simply means that all acquisitions, fixed assets and redemption of fixed liabilities are shown on the debit side and all disposals of fixed assets and rising of fixed liabilities are shown on the credit side. This part is called "Receipts and Expenditure on Capital Account" (This is simply called Capital Account)

NOTES

The second part of the balance sheet is called General balance sheet' this is prepared in the usual form of a Balance sheet- Assets and liabilities other than those shown in the capital account will be shown in the General Balance sheet. In addition, the total

of the debit side of the capital account will be shown on the credit side of the General Balance Sheet. In addition, the total of the debit side of the capital account will be shown on the credit side of the General balance sheet. Similarly the total of the assets side of the capital account will show on the liabilities side.

2. The Profit and Loss accounts is called the "Revenue account" and the Profit and Appropriation account is called the "net Revenue Account" However, there are a few exceptions such as

(a) Interest received and paid will be credited and debited to Net Revenue account and not to the ordinary Revenue account.

(b) Depreciation on fixed assets will be debited to Revenue account but credited to a separate "Depreciation Reserve Account". The cumulative balance of this Depreciation Reserve a/c will be shown on

the liabilities side of the General Balance sheet. This is because the fixed assets are shown at their gross figures in the capital account.

NOTE

CAPITAL A/C OR RECEIPTS & EXPENDITURE ON CAPITAL ACCOUNT

Expenditure	Expenditure up to the end of the previous year. Rs.	Expenditure during the year Rs.	Total Expenditure Rs.	Receipts	Receipts up to the end of the previous year Rs.	Receipt during the year Rs.	Total receipt. Rs.
To preliminary Expenses To Land To Building To Plant Total Expenditure To balance of capital account carried to General Balance Sheet				By Equity shares By preference shares Debentures Loans Calls in Advance Total Receipts			

NOTES

A Specimen Form of Revenue Accounting Is Given As Under Revenue Account For The Year Ending...19...

A General	Rs.		Rs.
To Fuel		By Building	
To Oil, wastage, water etc		H. Special charges	
To Salary of engineers		Too bad debts	
B. Distribution		Balance carried to Net	
To Salary of engineers		Revenue Account	
To Wages & gratuities			
To Repairs		By sale of energy for light	
C. Public Lamps		By sale of energy for	
To attendance Repairs Payments		power	
D. Rent, Rates & Taxes		By sale of energy for	
To Rent Payable		contracts	
To Rates & Taxes		By public Lighting	
E. Management Expenses		By Rent Receivable	
To Directors remuneration		By transfer fees	
To Management		By Other items	
To General Establishment		By Miscellaneous	

To Auditors of the company E. Law charges To Law charges G. Depreciation To Lease		Receipts By sale as ashes By Receiving and disconnection fees	

NOTES

The Specimen From Of Net Revenue Account Is Given As Under:
Net Revenue Account For The Year Ending…19…

	Rs.		Rs.
To Interest on Security Deposits To Interest on Fixed Loans To Contingency Reserve To Dividend Control Reserve To Reserve for Rebate to Consumers To Balance Carried to General Balance Sheet		By Balance from Last Account By Balance brought from Revenue A/c By Interest on Bank A/c	

NOTES

A Specimen from of General Balance Sheet is given below:

GENERAL BALANCE SHEET AS ON ...19...

	Rs.		Rs.
Capital Account (balance Carried forward from capital A/c)		Stores	
		Sundry Debtors	
Sundry Creditors for Capital A/c		Cash at Bank	
		Cash in Hand	
Sundry Creditors on open A/c			
Net Revenue Account			
Reserve Fund			
Depreciation Fund			
Special Items (to be specified)			

NOTES

The difference between the Double account system and the single account system (i.e. the system) may be simply illustrated as follows:

I. Double Account System:

RECEIPTS & EXPENDITURE ON CAPITAL A/C

Dr. **Cr.**

	Rs.		**Rs.**
Fixed Assets acquired	75,000	Equity capital raised	1,00,000
Balance	25,000		
	1,00,000		1,00,000

GENERAL BALANCE SHEET

LIABILITIES	**Rs.**	**ASSETS**	**Rs.**
Balance of capital a/c	25,000	Stock	20,000
Other liabilities(Crs, etc)	10,000	Debtors	10,000
Depreciation fund	3,000	Cash	8,000
	38,000		38,000

NOTES

II. Single Account System:

BALANCE SHEET

Equity Capital	1,00,000	Fixed assets	75,000	
Other Liabilities	10,000	Less Dep.	3,000	

				72,000
		Stock		20,000
		Debtors		10,000
		Cash		8,000
	1,10,000			1,10,000

Thus the chief features of Double Account System are:

1. Fixed assets are shown in the books at cost and not written down; therefore.
2. Depreciation of fixed assets will be credited and accumulated in a separate account (Depreciation Fund a/c) which appears on the liabilities side of the Balance Sheet.

NOTES

3. All long-term borrowings (like loans and debentures) are considered as capital items and therefore, interest on these loan funds will be debited to Revenue appropriation a/c like dividends on capital.
4. Discounts and premiums on Capital and debentures are retained as capital items.
5. Provisions for renewal are made out of current revenue.
6. The balance of the Receipts and Expenditures on Capital a/c is transferred to the General Balance Sheet (In the case of Electricity companies, the totals of the respective sides will be shown in the Balance Sheet).

The Double Account System is criticized on the following grounds.

1. The General Balance sheet does not provide as clear a picture with regard to fixed assets as in the usual Balance sheet. The assets are shown at cost in the capital account but the accumulated depreciation is shown in the General Balance sheet as a liability.
2. Assets having a very short life may be included in the capital account.
3. It is difficult (and sometimes impossible) to calculate the precise amount chargeable to Revenue a/c in respect of repairs and renewals – because the amount will be unequal over different years.
4. The final accounts under this system are not as simple and understandable to the general public as they are in the usual single account system.
5. Despite these criticisms, Double Account System is made compulsory in the case of Railways, Electricity companies Gas works and similar other undertakings which are incorporated under the special Acts of Parliament.

NOTES

Illustration: 1

The following are the balances on 31st December, 1982 in the books of the Kerala Power and Light Company Limited:

Particulars	Dr.	Cr.
	Rs.	Rs.
Land on December 31, 1981	60,000	
Lands, expended during 1982	2,000	
Machinery, on December 31, 1981	2,40,000	
Machinery, expended during 1982	2,000	
Mains, including cost of laying	80,000	
Mains, expended during 1982	20,400	
Equity shares		2,19,600
Debentures		80,000
Sundry Creditors		400
Depreciation Account		1,00,000
Sundry Debtors to current supplied	16,000	
Other Debtors	200	
Cash	2,000	
Cost of generation of electricity	14,000	
Cost of distribution of electricity	2,000	
Rent, Rates, and Taxes	2,000	
Management	4,800	
Depreciation	8,000	
Sale of current		52,000
Rent of meters		2,000
Interest on Debentures	4,000	
Interim Dividend	8,000	
Balance, Net Revenue Account December 31, 1981		11,400
	4,65,400	4,65,400

From the above Trial Balance, prepare Capital Account, Revenue Account,

Net Revenue Account and General Balance Sheet.

NOTES

SOLUTION:

Kerala Power and Light Company Limited

RECEIPTS AND EXPENDITURE ON CAPITAL ACCOUNT

For the year ended 31st December 1982

Expenditure	Upto the Previous Year	During the current year	Total	Receipts	Upto the Previous year	During the current year	Total
	Rs.	Rs.	Rs.		Rs.	Rs.	Rs.
To Land	60,000	2,000	62,000	By Equity Shares	2,19,600	-	2,19,600
To Machinery	2,40,000	2,000	2,42,000	By Debentures	80,000	-	80,000
To Mains	80,000	20,400	1,00,400				
Total Expenditure	3,80,000	24,400	4,04,400	Total Receipts	2,99,600	-	2,99,600
				By Balance c/d			1,04,800
			4,04,400				4,04,400

NOTES

REVENUE ACCOUNT For the year ended 31st December 1982

	Rs.		Rs.
To Cost of Generation	14,000	By Sale of Current	52,000
To Cost of Distribution	2,000	By Rent of Meters	2,000
To Rent, Rates & Taxes	2,000		
To Management expenses	4,800		
To Depreciation	8,000		
To Balance carried to Net Revenue A/c	23,200		
	54,000		54,000

NET REVENUE ACCOUNT
For the year ended 31st December, 1983

	Rs.		Rs.
To Interest on Debentures	4,000	By Balance b/d	11,400
To Interest Dividend	8,000	By Revenue A/c	23,200
To Balance carried to General Balance Sheet	22,600		
	34,600		34,600

GENERAL BALANCE SHEET AS AT 31ST December, 1982

LIABILITIES	RS.	ASSETS	RS.
Total Capital Receipts	2,09,600	Total Current Expenditure	4,04,400
Sundry Creditors	400	Sundry Debtors	16,000
Net Revenue A/c	22,600	Other Debtors	200
Depreciation	1,00,000	Cash	2,000
	4,22,600		4,22,600

Illustration: 2

The following balances are extracted from the books of Railway Company after completion of Revenue Account for the year ended 31st December 1980. You are required to prepare the Receipt and Expenditure on Capital account and the General Balance Sheet.

NOTES

	Cr. Rs.	Cr. Rs.
Equity shares		10,00,000
6% Preference shares		6,00,000
7 ½% Debentures		4,00,000
Lines open for Traffic	17,04,000	
Line in the course of construction	10,000	
Line Leased	40,000	
Working stock(Engines, Carriages etc)	2,60,000	
Lines jointly owned	1,00,000	
Freehold land	25,000	
Premium on shares		55,000
Cash at Bank	10,000	
General store and stocks	25,000	
Net Revenue Account		37,000
Traffic Accounts due to the company	20,000	
Due from other companies	7,000	
Sundry outstanding Accounts	5,000	
Due to other companies		3,000
Sundry creditors		26,000
Fire Insurance Fund		10,000
General Reserve		60,000
Superannuation Fund		15,000
	22,06,000	22,06,000

During the year there was an issue of Rs 2, 00,000 6% preference shares at par and this was fully subscribed. Equity shares of Rs 2, 50,000 were also issued at a premium of 10% expenditure on lines open for traffic Rs.50, 000 and lines in the course of construction Rs. 3,000 were and the construction to lines jointly owned Rs.15, 000.

RECEIPTS AND EXPENDITURE ON CAPITAL ACCOUNT For the year ended 31st December 1980

Expenditure	Expenditure up to 31-12-1976	Expenditure during the year	Total	Receipts	Receipts	Receipts	Total
	Rs.	Rs.	Rs.		Rs.	Rs.	Rs.
To Lines open for traffic	16,54,000	50,000	17,04,000	By Equity Shares	7,50,000	2,50,000	10,00,000
To lines on Construction	7,000	3,000	10,000				
To Lines leased	40,000	-	40,000	By 6% Preference shares	4,00,000	2,00,000	6,00,000
To Working stock	2,60,000	-	2,60,000	By 7 ½% Debentures	4,00,000	-	4,00,000
To Lines jointly owned	85,000	15,000	1,00,000	By Share Premium	30,000	25,000	55,000
To Freehold Land	25,000	-	25,000				
	20,71.000	68,000	21,39,000		15,80,000	4,75,000	20,55,000

NOTES

GENERAL BALANCE SHEET As on 31st December, 1980.

LIABILITIES	RS.	ASSETS	RS.
Amount received on Capital	20,55,000	Amount spent on Capital	21,39,000
A/c	60,000	A/c	25,000
General Reserve	37,000	General stores & stock	20,000
Net Revenue A/c	15,000	Traffic Account due	7,000
Superannuation Fund	10,000	Due from other Companies	5,000
Fire Insurance Fund	26,000	Sundry outstanding A/c	10,000
Sundry Creditors	3,000	Cash at Bank	
Due to Companies	22,06,000		22,06,000

Illustration: 3

Following is the Trial Balance of the Bright Electric Company as on 31st December 1980 amounts as on 31st December 1979 are also given for the necessary items. A call of Rs. 10 per share was payable on 30th June 1980. Arrears on share calls are subject to interest @ 5% P.A.

Trial Balance as on 31st Dec. 1980

Amount on 31st Dec. 1979 Rs.		Dr. Rs.	Cr. Rs.
	Equity share capital 500 shares of		
2,00,000	Rs. 100 each but Rs 50 called up		2,50,000
1,50,000	6% Secured Debentures		1,50,000
10,000	Depreciation Fund		10,000
-	Calles in arrears	10,000	
93,000	Freehold Land	93,000	
40,000	Buildings	50,000	
60,000	Machinery	1,00,000	
50,000	Mains	80,000	

NOTES

10,000	Transformers, Motors etc.	20,000	
5,000	Meters	15,000	
3,000	Electrical instruments	4,000	
16,000	Cables, Mains & other stores	23,500	
2,500	Furniture	2,500	
	Coal and fuel	19,000	
	Oil, waste, engine-room stores	7,500	
	Coal, oil, waste, in stock	1,000	
	Wages	30,000	
	Repairs and replacements	5,000	
	Rates and taxes	3,000	
	Salaries of Secretary, Manage etc	15,000	
	Director's Fees	10,000	
	Printing and stationary	6,000	
	Incidental expenses	3,000	
	Sale by meter		87,500
	Sale by contract		50,000
	Meter rents		3,000
	Sundry Creditors	45,000	
	Cash	35,000	
	Contingency Reserve		15,000
		5,75,500	5,75,500

1. **Depreciate:**

   (a) Buildings – 2 ½%

   (b) Machinery – 7 ½%

   (c) Mains – 5%

   (d) Transformers – 10%

   (e) Motors % Electrical Instruments – 15%

2. Transfer to contingency Reserve ½% of the cost of fixed assets

3. Depreciation on addition to fixed asset – may be charged for months

4. 4% interest to provide on Depreciation Fund

5. 4% interest to provide on Depreciation Fund.

You are required to prepare Capital account, Revenue Account Net Revenue Account and General Balance Sheet of the Bright Electric Company.

NOTES

BRIGHT ELECTRIC COMPANY Revenue account for the year ended 31st December 1980

Dr. Cr.

		Rs.		Rs.
A. Generation			By sale of energy by meter	
To Coal and Fuel	19,000		By sale of energy by contract	87,500
To oil, waste & engine-			By meter rents	
room stores	7,500			50,000
To wages	30,000			3,000
To Repairs & replacements	5,000			
		61,500		
B. Distribution		-		
C. Public Lamps		-		
D. Rents, Rate etc.				
To Rates & taxes		3,000		
E. Management				
Expenses	10,000			
To Director's fees	15,000			
To salaries of secretary etc.	6,000			
To Printing & Stationary	3,000			
etc.		34,000		
To Incidental expenses				

NOTES

F. Depreciation	1,125			
Depreciation on :	6,000			
Buildings	3,250			
Machinery	1,500			
Mains	1,500			
Transformers	525			
Meters	13,900	14,300		
Electrical instruments		1,12,800		
		27,700		
Add Interest @ 4% on		1,40,500		1,40,500
Depreciation Fund (Rs.	400			
10,000				
Total expenditure Balance				
carried to Net Revenue A/c				

Net revenue A/c for the year ended 31st December 1980

	Rs.		Rs.
To Interest on Debentures	9,000	By Balance b/d (last year a/c)	-
To Contingency Reserve –		By Balance brought from	27,700
transfer @ 1% on Rs.	1,940	Revenue A/c	
3,88,000 –	17,010	Interest due on calls in arrear (on	250
To Balance c/d	27,950	Rs. 10,000 @ 5% for 6 months)	27950

NOTES

Receipts & Expenditure A/C for the Year Ended 31st December 1980

DR. CR

Expenditure	Up to 31st dec. 1971 Rs.	During the year Rs.	Total Rs.	Receipts	Upto 31st dec. 1979 Rs.	During the year Rs.	Total Rs.
To freehold land	93,000	-	93,000	By Share Capital	2,00,000	40,000	2,40,000
To Buildings	40,000	10,000	50,000	By 6%			
To Machinery	60,000	40,000	1,00,000	Debentures	1,50,000	-	1,50,000
To Mains	50,000	30,000	80,000				
To Transformers	10,000	10,000	20,000				
To Meters							
To Cables, Mains & other stores	5,000	10,000	15,000				
To Electrical	16,000	7,500	23,500				
Instruments	3,000	1,000	4,000				
To Furniture	2,500	-	2,500				
Total Expenditure	2,79,500	1,08,500	3,88,000		3,50,000	40,000	3,90,000
To Balance c/d			2,000				
			3,90,000				

GENERAL BALANCE SHEET AS ON 31ST December 1980

LIABILITIES		RS.	ASSETS	RS.
Capital a/c amount received		3,90,000	Capital a/c amount expended	3,88,000
Sundry Creditors		10,000	Stores on Hand	1,000
Contingency Reserve		16,940	Sundry Debtors	45,000
Net Revenue a/c Balance		17,010	Interest due on calls in arrears:	250
Depreciation Fund:			Cash	33,000
Opening balance	- 10,000			
Addition during the year	- 14,300			
	------------	24,300		
Interest on Debentures		9,000		
		4,67,250		4,67,250

REPLACEMENT OF AN ASSET:

The distinction between capital and revenue expenditure is very important in double account system. Whenever there is a question of replacement of an asset the problem arises as to what portion of expenditure should be charged to capital or revenue expenditure. Under single account system whenever an asset is replaced old asset is completely written off and the cost of new asset is capitalized. But under double account- system, the procedure is as under:

NOTES

1. The original cost of the asset to be replaced is not touched at all and continues to be shown in the books even after its replacement.
2. The estimated cost of the replacement of old assets is calculated assuming that if this asset is constructed what it will cost. Out of this estimated cost the sale proceeds of old materials and value of materials reused is deducted. The residual amount is charged to the revenue account.
3. The difference between the total cost of the work and the estimated replacement cost (without reducing it by amount of material used or sold of the old asset is capitalized.

The accounting entries will be ---------------

1. **For the amount spent on new works:**

New Works Account Dr.

(With the amount to be written off to revenue)

Replacement Account Dr.

(With the amount to be written off to revenue)

To Bank Account

(Actual amount spent)

2. **For the sale of old materials:**

Bank Account Dr.

To Replacement Account

NOTES

3. **For the value of old materials used in the construction:**

New Works Account Dr.

To Replacement Account

4. **Amount entirely spent on extensions:**

New Works account Dr.

To Bank Account

Illustration 4:

A water supply concern had to replace a quarter of the mains and lay on auxiliary main for the remaining length in order in augment supplies of water to a locality. The total cost of the original main was Rs.16, 00,000. The auxiliary main cost Rs. 18, 00,000 and the new main cost Rs. 7, 00,000. It is estimated that cost of laying a main has gone up by 30% Parts of old main realized Rs. 50,000.

Pass the necessary journal entries to record the above transactions.

NOTES

Solution:

JOURNAL ENTRIES

		Rs.	Rs.
Newman(works) A/c Dr.		18,00,000	
To Bank A/c			18,00,000
(being the amount expired for the cost of the main)			
Main (works)A/c Dr.		1,80,000	
Replacement A/c Dr.		5,20,000	
To Bank A/c			7,00,000
(Being the cost of replacement allocated between capital and revenue)			
Bank A/c Dr.		50,000	
To Replacement A/c			50,000
(being the amount realized by the sale of old main)			
Revenue A/c		4,70,000	
To Replacement A/c			4,70,000
(being the amount of loss charged to revenue account)			

Workings:

CALCULATION OF AMOUNT TO BE CAPITALISED:

1. COST OF NEW Auxiliary main

   (Amount to be capitalized) Rs. 18, 00,000

   7, 00,000

2. Cost of new main The capitalized value debited to works account

NOTES

Less: new cost of construction of old main to be replaced: Original cost of ¼ of original Main to be replace (1/4 16, 00,000) = 4,00,000

Add: Increase in cost at 30% = 1,20,000

Rs. 5,20,000

Addition to the main A/c (amount to be capitalized) 1,80,000

Calculation of revenue charge:

New cost of old main	Rs. 5,20,000
(1/4 of the original main)	Rs. 50,000
Total revenue charge	Rs..4,70,000

NOTES

Illustration: 5

The Bombay Electronic Co. Ltd. Rebuit and reequipped a part of their power house at a cost of Rs. 80,00,000; the part of the old power house thus superseded had cost originally Rs. 50,00,000 but if erected at the present time would cost 20% more. Rs. 50,00,000 is realized from the sale of old materials and Rs. 4,00,000 worth of old materials are used in the reconstruction and are included in the cost of Rs. 80,00,000 mentioned above. Give necessary entries for recording the allocations between capital and revenue and give reasons for such allocations.

Solution:

CALCULATION OF COST OF CAPITALISATION:

	Rs.	Rs.
Total cost of construction		80,00,000
Less: Revised amount of Construction cost of that portion of old structure which is to be replaced:		
Original cost	50,00,000	
Add: Increase in value	10,00,000	
		60,00,000
Total amount of capitalization		20,00,000

NOTES

CALCULATION OF REVENUE CHARGE:

Revised amount of constructions of old structure	60,00,000
Less: Value material used and sold(4,00,000+5,00,000)	9,00,000
Net loss charged to Revenue Account	51,00,000

CALCULATION OF CASH OUTLAY:

Total cost of construction	80,00,000
Less: Material used	4,00,000
Cash spent	76,00,000

JOURNAL ENTRIES

			Rs.	Rs.
1	Replacement A/c Dr. To Bank A/c (total cost Rs. 80,00,000 Less: material used Rs. 4,00,000 (being the amount spent on replacement)		76,00,000	76,00,000
2	Bank A/c Dr. To Replacement A/c (being the amount realized by the sale of old materials)		5,00,000	5,00,000
3	Works A/c Dr. Revenue A/c Dr. To Replacement A/c (being the amount capitalized debited to works account and the amount of loss charged to revenue account)		20,00,000 51,00,000	71,00,000

NOTES

LESSON- 18

ACCOUNTING FOR PRICE LEVEL CHANGES

INTRODUCTION

"Money measurement concept" is a Basic concept of Accounting. All business transactions are recorded in the books of accounts in terms of "money"-Rupees in India, dollars in U.S.A., etc. The accounting cycle culminates in the preparation of financial statements-profit and loss account and Balance sheet which aim at ascertaining the net result of business operations of a period and true and fair view of the financial position of the business. The reliability of the accounts and financial statements depends on the "stability" of the unit for recording –rupee or dollar. In fact stability of the monetary unit is the basic assumption of Historical cost Approach (HCA). "HCA" presumes that money value is constant and the price-level over a period of time is stable. Fixed assets acquired are recorded at the "cost of purchase" (Cost concept). Liabilities are recorded at the amounts contracted for. Sales are shown at the current market prices, where as inventories are valued at the prices at which they were purchased.

The historical cost approach which governs recording of business transactions can serve the purpose if the basic assumption holds good i.e., "Monetary unit" remains the same. However, from the time of "great depression" before the Second World War, changing price levels characterized but inflation has become

routine. In the past three decades, rising prices reflecting rampant inflation have become a worldwide phenomenon. Double digit rates of inflation have become common in many countries. In India, the inflation rate oscillates between 4% and 10% p.a.

The changing price levels resulting from inflation have adversely affected the "stability of the monetary unit". As a result, the reliability of the financial statements is seriously affected. The fixed assets recorded at cost less depreciation do not reflect the current market values or replacement values. The price levels at which goods are bought and sold are different. Inventories are shown at unrealistic prices, not revealing their true value. To sum up, operating results shown by a business have become unreliable and the balance sheet does not reflect true and fair view of the financial position of a business.

Limitations of Historical Accounting

1. Unrealistic values of Fixed assets
2. Insufficient depreciation provision
3. Problems in replacement of Fixed assets
4. Inflated profits
5. Erosion of owners capital
6. Reliability and utility of Accounting records
7. Violation of Matching principle
8. Holding and operating gains
9. Violation of the law of additively

10. Inter-firm and intra-firm comparisons

11. Managerial decision making.

INFLATION ACCOUNTING

The limitation of historical accounting has paved the way for inflation accounting.

The various ways in which financial accounts can be adjusted for changing prices have come go is known as "inflation accounting". It is a system of accounting which regularly records all items in financial statements at their current values. It recognizes that the purchasing power of money changes with passage of time. It finds out profit or loss and presents the financial position of the business on the basis of the current prices prevailing in the country.

According to the American Institute of Certified public Accountants (AICPA), "Inflation Accounting is a system of accounting which purports to record, as a built-in mechanism, all economic events in terms of current cost."

Different Methods of Inflation Accounting

1. Current purchasing power method (CPP) or General purchasing power method (GPP)
2. Current cost accounting method (CCA)
3. Hybrid method, which combines the features of both CPP and CCA methods.

NOTES

ILLUSTRATION-1

A real estate company started with a capital of Rs. 50,00,000 which was invested in urban land on 1-1-90. On that date the general price index was 100 and specific price index for land was 200. The company had no other transactions and it sold the land on 1-1-95 on which date the general price index was 180 and the specific price index was 420. The sale price of the land was Rs. 1,80,00,000.

You are required to ascertain profit under (1) Historical cost (2) CCA method and (3) CPP method.

Solution

Statement showing Comparative Profit

Particulars	HCA Rs.	CCA Rs.	CPP Rs.
Investment in Land	50,00,000	50,00,000	50,00,000
Current cost of Investment on the date of sale	-	1,05,00,000	90,00,000
CCA (50,00,000*420/200) CPP	1,80,00,000	1,80,00,000	1,80,00,000
(50,00,000*180/100)-	1,30,00,000	75,00,000	90,00,000
Sale Value of Land	-	55,00,000	40,00,000
Operating gain	1,30,00,000	1,30,00,000	1,30,00,000
Realized holding gain			
Total Gain			

NOTES

ILLUSTRATION 2

A Truck dealer acquired 6 trucks on 1-1-97 at Rs.2, 00,000 each. His capital on that date was Rs.12, 00,000. During the year he sold 4 trucks at an average price of Rs. 3, 00,000. The replacement dealer price of the truck on 31-12-97 was Rs. 2, 40,000. General Price level went up by 10% during the year.

You are required to show (1) Comparative income statement under HCA, CPP and CCA methods, clearly showing the realized and unrealized holdings gains.

(2) The balance sheet under all the three methods.

Comparative Income Statement for the year ended 31-12-97

Particulars	HCA Rs.	CCA Rs.	CPP Rs.
Sales	12,00,000	12,00,000	12,00,000
Less: Cost of goods sold	8,00,000	9,60,000	8,80,000
Operating Gains	4,00,000	2,40,000	3,20,000
Add : Realized holding gains	-	1,60,000	80,000
Realized income	4,00,000	4,00,000	4,00,000
Add : unrealized Holding gain	-	80,000	40,000
	4,00,000	4,80,000	4,40,000

Note: Cost of goods sold – HCA – 2, 00,000 * 4 = Rs. 8, 00,000
CCA – 2, 40,000 * 4 = Rs. 9, 60,000
C.P.P (2, 00,000+10%)*4 = Rs. 8, 80,000
Realized holding gain – CCA = (2,40,000- 2,00,000)*4 = Rs. 1,60,000
CPP – (2,20,000-2,00,000)*4 = Rs. 80,000
Unrealized holding gain CCA 40,000*2 = 80,000
CPP 20,000*2 = 40,000

NOTES

Balance sheet as on 31.12.1997

Particulars	HCA Rs.	CCA Rs.	CPP Rs.
Assets :			
Cash	12,00,000	12,00,000	12,00,000
Stocks	4,00,000	4,80,000	4,40,000
	16,00,000	16,80,000	16,40,000
Liabilities:			
Capital	12,00,000	12,00,000	12,00,000
Operating profits	4,00,000	2,40,000	3,20,000
Realized holding gain	-	1,60,000	80,000
Unrealized holding gain	-	80,000	40,000
Total Liabilities	16,00,000	16,80,000	16,40,000

CPP – METHOD

Conversion Factors

Illustration 3

From the following details compute appropriate conversion factors.

(a) General price index numbers – opening 200; closing 300; average for the year 240

(b) General price index numbers – at the end of the year 200. On the date of acquiring an item of stock 120. On the date of acquiring an asset 150.

Solution

(A) For opening items = Closing index/ opening index = 300/200 = 1.5

For items resulting from transaction during the year like sales, salaries, etc.

= Closing index/average index = 300/240 = 1.25

(B) For ascertaining value of the stock = Closing index/ Index on the date of acquiring stock

= 200/120 = 1.667

For ascertain asset value = closing index / Index on the date of acquiring the asset

= 200/150=1.333

NOTES

Gain or loss on monetary items

Illustration 4

The following information is given to you regarding X Ltd., for the financial year ended 31.3.1997.

	1.4.96 Rs.	31.3.97 Rs.
Monetary Assets	80,000	80,000
Monetary liabilities	1,00,000	1,00,000
Retail price index	200	300

Ascertain gain or loss on monetary items

Solution

Statement showing monetary result of X Ltd for the year ended 31.3.1997

Particulars	Rs.	Rs.
Monetary liabilities on 1.4.96 should have gone up in line with general		
prices upto 1,00,000*1.5	1,50,000	
But the liabilities stayed at	1,00,000	
Gain on holding of monetary liabilities		50,000
Monetary assets on 1.4.96 should have gone up in line with general	1,20,000	
prices upto 80,000*1.5	80,000	
But the assets stayed at		40,000
Loss on holding of monetary assets		10,000
Net gain on monetary items		

Working note: Conversion factor for items on 1.4.96 = Closing index number / opening index
= 300/200 = 1.5

NOTES

Illustration 5

Ascertain net monetary result or 'general price level gain or loss' from the following information.

Particulars	1.1.98 Rs.	31.12.98 Rs.
Cash and bank balance	60,000	88,000
Accounts receivable	80,000	1,00,000
Accounts Payable	1,00,000	1,24,000
General retail price index number	100	125

Average index number for the 120.

Solution

Statement showing net monetary result

Particulars	Rs.	Rs.
Monetary liabilities on 1-1-98 should have gone up in line with general prices upto (1,00,000*1.25)	1,25,000	
Increase in liabilities during 1998 should have gone up in line with general prices upto 24,000*25/24	25,000	
	1,50,000	
	1,24,000	
But the liabilities stayed at		26,000
Gain on holding of monetary liabilities		
Monetary assets on 1.1.98 should have gone up in line with general prices upto 1,40,000*1.25	1,75,000	
	50,000	
Increase in monetary assets during 1998 should have gone up in lice with general prices upto 48,000*25/24	2,25,000	
	1,88,000	
		37,000
But the monetary assets stayed at		-
Loss on Holding of Monetary assets		11,000
Net loss on monetary items		

Working notes:

(1) Monetary assets and liabilities:

Liabilities	1.1.98 Rs.	31.12.98 Rs.	Addition during 1998 Rs.
Cash and Bank balances	60,000	88,000	28,000
Accounts receivable	80,000	1,00,000	20,000
Monetary assets	1,40,000	1,88,000	48,000
Accounts payable	1,00,000	1,24,000	24,000
Monetary liabilities	1,00,000	1,24,000	24,000

(2) Conversion factors:

For items on 1.1.98 = Closing index number / opening index number = 125/100 = 1.25

For increase or decrease in items during the year = Closing index number/Average index number

=125/120=25/24=1.042

NOTES

Exercises

1. Toby Investments ltd., started with a capital of Rs.2,00,000 on 1-1-93 on which date they purchased real estate property for that amount. The general price index on that data was 120 and specific price index for real estate was 200. The company sold the property on 1-1-96for Rs. 4,60,000. On that date the general price index was 180 and the specific price index was 320.

You are required to ascertain profit on the purchase and sale of the property under (1) HCA (2) CCA and (3) CPP methods of accounting.

[Ans: Operating profit : HCA – Rs. 2,60,000; CCA – Rs. 1,40,000; C.P.P – Rs. 1,60,000; Realized holding gain: CCA- Rs. 1,20,000; CPP- Rs. 1,00,000]

2. Goods were purchased on 1-1-90 for Rs. 1,00,000. 80% of them were sold during the year for Rs.1,20,000. Specific index for this line of goods went up by 20% during the year and the general price index moved up by 15%. You are required to find out the operating gain, realized and unrealized holding gain during the year under CCA method and CPP method.

[Ans: Operating gain: CCA-Rs.24,000; CCP-Rs. 28,000; Realized holding gain CCA-Rs.16,000; CPP- Rs. 12,000; Unrealized holding gain CCA Rs.4,000; CPP-Rs.3,000]

3. Mr. X. started business with a capital of Rs.4,00,000 and invested Rs.6,00,000 in 5 second hand cars bought at Rs.1,20,000 each. For this purpose, he obtained a loan (interest free) of Rs.2,00,000 from his brother. He sold 41 cars during the year at an average price of Rs.1,80,000. At the end of the year, similar cars cost Rs.1,40,000 showing operating and holding gains. Also prepare balance sheet at the end of the year, under the three methods.

Ans.

	HCA	CCA	CPP
Operating gain	2,40,000	1,60,000	1,92,000
Realized holding gain	-	-	-
Unrealized holding gain	-	20,000	12,000
Balance sheet Total	8,40,000	8,60,000	8,52,000

NOTES

LESSON-19

HUMAN RESOURCE ACCOUNTING

Human Resources are the most valuable resources of any organization. The success of failure of an organization mainly depends on the quality, caliber and character of the people who are employed in the organization. Different organizations employ different classes of workers according to the requirements of the job/work. In educational institutions, teachers, who put in a lot of hard work, are responsible for the overall development of the students. But, their hard work and efforts are not assigned any monetary value and not shown anywhere in the Balance sheet of the concerned educational institution. Similarly, in corporate sector, the directors, considered as the pillars of the company, are responsible to make vital decision on various aspects so as to enhance the earning capacity of the company. The potential investors are willing to invest their hard earned money in those companies where eminent directors are present. Unfortunately, the contributions of great leaders like Mahatma Gandhi, sardar Vallabhbhai Patel and Jawaharlal Nehru cannot be forgotten in the freedom movement of India. But no one made efforts to assign any monetary value to such individuals in the Balance sheet of the Nation. So, human elements are completely ignored while recording the transactions in the books of accounts. Unless efforts and contributions of people are measured in terms of money, it is not possible to understand the real value human beings present in the organization. In order to ascertain the value of human beings, a new system of accounting has been evolved which is popularly known as "Human Resource Accounting". (HRA)

Meaning of HRA

HRA refers to accounting for people as an "organizational resource". It involves measuring the costs incurred by business firms and other organizations to recruit, select, hire, train and develop "human assets". It also includes measuring the economic value of people to organizations. It serves both the internal and external users, providing management (internal users) with relevant data on which to base recruiting training and other development decisions and supplying investors, lenders and other external users of financial statements with information concerning the investment in and utilization of human resources in the organization.

Definition of HRA

i) Woodriff, "HRA is an attempt to identify and report investments made in human resources of an organization that are presently not accounted for in conventional accounting practice. Basically, it is an information system that tells the management what changes over time are occurring to the human resources of the business."

ii) The American Accounting Association's Committee," HRA is the process of identifying and measuring data about human resources and communicating this information to interested parties.

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Objectives of HRA

The following are the major objectives of an HRA system:

i) To provide quantitative information for making managerial decisions about acquiring, allocation, developing and maintaining human resources in order to attain cost effective organization objectives.

ii) To permit managerial personnel to monitor effectively the use of human resources.

iii) To help in the development of management principles by classifying the financial consequences of various practices;

iv) To recognize the nature of all resources used or cultivated by a firm and improvement of the management of human resources, so that the quality and quantity of goods and services are increased.

v) To evaluate the return on investment of human resources,

vi) To communicate the value of human resources to the organization and the society at large.

From the above, it is quite evident that there are several important aspects of HRA as given below:

1. Valuation of human resources;
2. Recording the valuation in the books of accounts and
3. Presenting the information in the financial statements for communication

1. Valuation of Human Resources

Valuation of human resources can be made on the basis of either the "cost of the resource" or a basis of "economic value of resource". Therefore, different methods of valuation of human resources can be classified into the following two categories viz.

a) Cost base methods of human resource valuation,
b) Value based methods of human resource valuation

a) Cost based Methods of Human Resource Valuation:

1. Historical Cost Method
2. Replacement cost method
3. Opportunity cost method
4. Standard cost method
5. Total cost method

(a) Historical cost method: This method of valuing human resources was first developed by William C. Pyle and R.G Barry Corporation, USA in 1967. Under the method actual costs incurred on recruiting, selecting, hiring, training and developing the human resources of the organization are capitalized and amortized over the expected useful life of the human resources. Thus, a proper record of the expenditure made on hiring, selecting, training and developing the human assets is maintained and a part of it is written off from the income of the next few years during which human resources will provide service. If the human resources expire before the end of the expected useful life, the whole of the amount not yet written off is charged to the revenue of the year in which such liquidation takes place.

The valuation of human resources, under this method, is similar to valuation of any physical asset. The most important limitation of this

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method is that historic costs are not relevant for decision making and are useless. The data may be of some use to managers in calculating ROI human resources, planning and controlling expenditures for human resource development activities, etc., but will be of no use to investors because this method does not give a correct value of human resources. The capitalized figure of human resources under this method merely indicates the 'unamortized balance' of the costs and does not give any indication of the 'potential benefits' that accrue to the organization from the use of such resources.

(b) **Replacement Cost Method:** This method, first suggested by Rensis Likert, was developed by Eric G. Clamholtz. Under this method, the human resources are valued at their present replacement cost. If a new organization has to be started now, the cost of recruiting, selecting, hiring, training and developing human resources to their present efficiency level will be considered as the value of human resources of the organization.

This method is more realistic as it incorporates the current value of company's human resources in its financial statements prepared at the end of the year. Though this method comes closer to the ideal method of asset valuation, yet it suffers from two short-comings (1) there may be no similar, certain existing assets, (2) the determination of a replacement value is affected by the subjective considerations and, therefore, the value is likely to differ from man to man.

There are two views regarding replacement cost i.e. positional and personal. Positional replacement cost refers to the sacrifice that would have been incurred if a person presently employed in a specified position were to be replaced today with a substitute capable of providing an equivalent set of services in that given position. Positional replacement cost typically comprises (!) acquisition and learning costs, and (2) separation costs. On the contrary, personal replacement cost refers to the sacrifice to be incurred to replace a person today with a

substitute capable of providing an equivalent set of services in all the positions that the former might occupy. These concepts of replacement cost can be extended to groups as well as individuals, though emphasis has been on individuals as the basic unit of analysis.

(c) **Opportunity Cost Method:** This method was first advocated by Hekimian and Jones under the method, the value of human resources is ascertained on the basis of its alternative use. i.e., on the basis of ability off doing other jobs. If an employee has no alternative use, he has no value according to this method. To put it in a nutshell, the value of an employee of one department can be determined on the basis of the offers made by other departments of the organizations for his service.

(d) **Standard Cost Method:** This method was propounded by David Watson. Under the method, the standard cost per grade of employee for recruiting, selecting, hiring, training and developing is determined year after year. The standard cost so arrived for all employees of the organization, when aggregated, gives the value of human resources of the organization. The standard costs of recruitment, training and developing individuals, can be developed on the basis of replacement costs. The standard costs for various purposes are also useful to compare the actual and analyze the variations from standards.

(e) **Total Cost Method:** This method was advocated by Prof.N.Dasgupta. under the method, the total expenditure incurred by the organization towards education and training of an employee so as to make him efficient in his present level or to make him fit for the organization's requirement, it taken as the value of an employee. To an organizational such value is to be adjusted every year on the basis of age, experience, seniority, status, performance, etc.,

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(B) Value based methods of Human Resources Valuation:

The following are the various methods under this category:

(a) Unpurchased Goodwill method or capitalization of super profits method.

(b) Present value of future earnings method.

(c) Rewards valuation method.

(d) Net benefit method.

(e) Total payment method.

(a) Unpurchased Goodwill Method or Capitalization of Super profits method:

This method was developed by Hermanson. Under the method, the value of human resources of an organization is measured by capitalizing the earnings of the business in excess of normal earnings earned from similar type of business. The excess or super earnings of the business is assumed to be due to the better resources of the organization and accordingly capitalized as the value of the human resources.

(C) **Present Value of future earnings method:** This method was developed by Brauch Lev and Aba Schwartz in 1971. Under the method, the value of human resources is found out by capitalizing the salary, and other remuneration payable till the age of retirement. The value of an employee can be ascertained by using the following formula.

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$$Vr = \frac{I\ (t)}{(I+R)\ t\text{-}r}$$

Where, Vr = the value of an individual r years old.

I (t) = the individual's annual earnings up to the retirement.

t = Retirement age.

R = a discount rate specific to the person.

The value per employee, as computed above, multiplied by the total number of employees in the organization, gives the total value of human resources of the organization. The above formula, however, ignores the possibility of death prior to retirement. But that can be easily taken care of by visualizing "E" as the age at which the employee may die, if that is before retirement. Mortality tables can help in this regard. Infosys Ltd., in India used the method to value its human resources in 2003-04 and 2004-05.

The method ignores the possibility of a person moving from one career to another and the possibility of early exit. The most important limitation of this method is that it assumes remuneration of an employee being equal to his value. Further, the synergistic effect is totally ignored.

(D) **Rewards valuation method:** This method was suggested by Flamholtz, the method removes the defects of the previous method and value of the human resources on the basis of their discounted earnings in the future taking into account changes in their service and the possibility of early retirement. The expected realizable value of an employee, under the method, is calculated by applying the following formula.

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E (RV) = tn=1(i-1 m) R1-P (Ri)

(1+r)t

Where, E(RV) = A person's expected realizable value

Ri = value R to be derived by the organization for each position I

P(Ri) = probability that an individual would occupy position

t = time of retirement

m = state of exit

r = discount rate

This method suggests a five step approach for ascertaining the value of an individual to the organization.

- First of all, anticipate the period a person will remain in the organization i.e. his expected service life;
- Second, identify the service states i.e. the roles he might occupy;
- Third, estimate the value derived by the organization when a person occupies a particular position for a specified time period;
- Fourth, estimate the probability of occupying each possible mutually exclusive state at specified future times;
- Finally, discount (at a specified predetermined rate) the expected service rewards to their present value.

This method is certainly an improvement over the present value of future earning method. But according to Jaggi and Lav, this method falls short of a practical value in as much as that 'probabilities will have to be determined for each individual occupying various service states for n period on individual basis and would be tremendously expensive and time consuming and will involve large variance reducing its usefulness.

(D) **Net Benefit Method:** This method was suggested by Morse in 1972. Under the method, the value of human resources is equivalent to the present value of the net benefits derived by the enterprise from the service of its employees. That is, the value of human resources of an organization is

[Gross value of future services rendered [Value of future Present value of

By the employees] payment to employees] * annuity at a

Predetermined

Discount rate (usually cost of capital for the future period.

(E) **Total payment method:** This method was advocated by Prof. S. K. Chakra borty (1976) the first Indian to suggest a model on human resources of an organization. Under this method the value of human resources is not calculated on individual basis but in aggregate e. however, managerial and non-managerial man power can be evaluated separately.

(F) **Recording and Presenting in Financial Statements**

So far the various methods of calculation of value of human resources of an organization have been discussed in detail. In India, Human Resources Accounting has not been recognized as a system of accounting. The Indian Companies Act 1956, does not give any specific instruction about inclusion of human resources in the financial statements or in notes or in schedules. However, there are twelve major companies in India which have adopted the concept of human resource accounting so far, the data of only five companies is compatible for comparison. The companies are:

(1) Bharat Heavy Electrical Company (BHEL): This is the first Indian company, which has published human resource accounts from 1974-75

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onwards and considered as one of the FORTUNE 500 Companies listed outside U.S.A.

(2) Steel Authority of India Ltd (SAIL): This is a holding company, comprising five integrated steel plants and two alloy steel units in the public sector:

(3) Minerals And Metals Trading Corporation(MMTC): This is the biggest trading organization in India;

(4) Southern Petrochemical Industrial Corporation Ltd (SPIC): This is one of the biggest diversified organizations in the Joint Sector, producing fertilizers, chemicals, electronics, etc.

(5) Infosys: The Company valued its human resources at Rs.28, 334 crores in 2004-05.

Most of the Indian Companies adopted the present value of future earning method in the sense that they have calculated the present value of future direct and indirect payment to their employees as the basic framework of human resource valuation. MMTC has considered 12%; Infosys has discounted its earnings at 13.63% in 2004-05 and at 14.09% in 2003-04, while SAIL has applied 14% to get the present value of human capital. BHEL also reported human resource value similarly, using 12% discount factor on the future earnings of employees. The human resource accounting is usually presented in the form of supplementary information attached to the financial statements in annual reports, which are basically meant for external reporting.

Advantages of HRA:

(1) HRA provides relevant information to the management enabling it to take appropriate decisions in matters relating to human resources like recruitment, selection, hiring, training and development, etc.,

(2) It helps management or Judge the adequacy or otherwise of the resource and go in for further recruitment, if necessary.

(3) It brings in awareness in the employees about their levels of efficiency and performance, and thereby provides an opportunity for their improvement.

(4) It recognizes the importance of an individual and thus promote the intellectual and social growth thereby facilitating the achievement of economic goals of the organization as well.

(5) It is useful to an investor or an analyst to get the complete picture about the effectiveness of application of funds by the organization.

(6) It also helps management to reorient their attitudes towards labour and in improving their leadership styles.

Limitations of HRA:

(1) There are no specific and clear-out guidelines for ascertaining 'cost' and 'value' of human resources of an organization. The existing valuation methods suffer from many drawbacks.

(2) If the cost of measuring hum an resource value is higher than the benefits derived from it, the entire effort would be a waste and uncalled for.

(3) The life of human resources is uncertain and, therefore, valuing them under uncertainty seems unrealistic.

(4) No law considers human resource as an asset, making human resource accounting just a theoretical concept.

(5) The much needed empirical evidence is yet to be found to support the hypothesis that HRA, a managerial tool, facilitates better and effective management of human resources.

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(6) The behavior of human resources being unpredictable in nature, the ouput in any form is difficult to estimate, proving every model as insufficient and incomplete.

(7) There is a constant fear of opposition from the trade unions. Placing the value of employees on record would prompt them to seek rewards and compensation based on such valuation.

(8) When the existing pay structure, promotion policies, training polices, etc., are not structure, human resource valuation, based on such weak structure may not be appropriate.

(A) **Short Answer Questions:**

1. What is human resource accounting?
2. State the process of human resource accounting.
3. Enumerate the various methods of valuation of human resources.
4. List the different cost based methods of human resources valuation.
5. Mention the various value based methods of human resource valuation.
6. How is human resource valued under 'Historical cost method'?
7. Explain opportunity cost method of evaluating human resources?
8. What do you understand by 'unpurchased Goodwill' method?
9. State the formula for valuation of human resources under 'present value of future earning method.'
10. Write the formula under 'Rewards valuation method' of Human Resource Accounting.
11. Explain briefly the Net Benefits Method of valuing human resources.
12. State the formula used under 'Total Payments Method' for valuing human resources.

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(B) **Long Answer Questions:**

(1) **Give** the meaning and significance of HRA.

(2) Define human resource accounting and explain the objectives of this system.

(3) What is the need for HRA? Trace briefly the development of HRA.

(4) What are the objections against or limitations of human resource accounting?

(5) What are the objections against or limitations of human resource accounting?

(6) List the principal failures of conventional accounting in relation to human resources.

(7) Explain the various approaches for the valuation of Human Resources.

(8) Distinguish between: (1) Historical cost approach and replacement cost approach

(2) Net benefit model and equivalent net benefit method.

(9) Explain the various methods of valuation of human resources.

(10) Explain the various 'cost based methods' of valuing human resources.

(11) Explain the different 'value based methods' of valuing human resources.

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What is Lease?

A contract granting use or occupation of property during a specified time for a specified payment

LESSON-20

LEASE ACCOUNTING

The important functions of a finance manage is to determine the sources from which the funds required for capital investment are to be raised. The term capital investment includes investments in fixed assets, such as, land and building. Plant and machinery and other fixed assets, which are needed for a long-term use in the business. Such funds may be raised either through internal financing or through external financing. The expenditure in capital assets is a sunk investment. It bestows on the firm the ownership rights and also the responsibility of all consequential gains and losses if such assets are to be disposed of at a later stage. An alternate to own and use the capital assets is to them on lease and use them as per the terms of the leasing agreement.

A contract of lease may be defines as 'a contract whereby the owner of an asset (lessor) grants to another party (lessee) the exclusive rights to use the asset usually for the agreed period of time in return for the payment of rent. "In other words, a contract of lease provides a person (lessee) an opportunity to use an asset,

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which belongs to another person (lessor). In a lease transaction, therefore, the two important rights to the property-

(1) Right to own, and (2) right to use- are differentiated.

The important steps involved in a leasing transaction can be summarized as follows:

1. First, the lesee has to take a decision about the asset required and determines the manufacturer or the supplier. He also decides about his other requirements, viz., the design specifications, the price, warranties, terms of delivery, installation and servicing.
2. The lessee then enters into a lease agreement with the lessor. He specifies to him his requirement as determined by him under point (1) above. The lease Agreement contains the obligations of the lessor and the lessee as given below:

(1) The basic (or primary) lease period during which the lease is irrevocable.

(2) The timing and amount of periodical rental payments during basic lease period.

(3) Details of any option to renew the lease or to purchase the asset at the end of the basic lease period. In the case of absence of any such option to the lessee, the lessor takes possession of the asset and is entitled to any residual value associated with it.

(4) Details regarding the responsibility for payment of cost of maintenance and repairs, taxes, insurance and other expenses. In case of a "Net Lease Agreement", the lessee pays all these costs. However, in case of a

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"Maintenance Lease Agreement", the lessor maintains the asset and also pays for the insurance.

3. After the lease agreement is signed, the lessor contracts the manufacturer or supplier to supply the asset to the lease. The lessor makes payment to the manufacturer or the supplier after the asset has been delivered, tested and accepted by the lessee.

The lease agreements can broadly be put into following four categories.

1. Capital Lease

A Capital Lease is a long-term arrangement, which is irrevocable during its primary lease period. According to FAS-13, a Capital Lease is one, which satisfies one or more of the following conditions:

(A) The lessor transfers title to the lessee at the end of the lease period.

(B) The lease contains an option to purchase the asset at a bargain price.

(C) The lease period is equal to or greater than 75% of the estimated economic life of the asset.

(D) At the beginning of the lease, the present value of the minimum lease payments equals or exceeds 90% of the fair value of the leased property to the lessor (less any investment, tax credits, realized by the lessor).

In case of a capital lease, practically all the risks incidental to the ownership of the asset and the benefits arising there from are transferred to the lessee except the legal

title which may or may not be eventually transferred. The lessee has also to bear cost of insurance, repairs and maintenance of the asset and other related expenses. The Capital Lease is also termed as "Close end Lease" since the lease agreement more or less is irrevocable and the rental payments are so fixed that they ensure return of the total investment at a predetermined rate of return.

2. Operating Lease

A lease which does not satisfy any of the conditions as given above for Capital Lease is termed as "Operating Lease". Such a lease agreement gives the lessee the right to use the leased property for a limited period of time. It does not give lessee all the benefits and risks that are associated with the asset. The lessor is responsible for the maintenance of the asset, insurance and all other relevant expenditure. An operating Lease general lay preferred in the following circumstances:

(a) Where there is possibility of rapid obsolescence of the asset.

(b) Where the lessees is interested in tiding over a temporary problem.

The operating lease is also termed as an "Open-end Lease Arrangement" since the lessee has the option to terminate the agreement by notice.

3. Sale and Lease Back

In case of a sale and lease back arrangement; a firm sells an asset to another person who in turn leases it back to the firm. The asset is generally sold at its market value. The firm receives the sale price in cash and gets the right to use the asset during the basic lease period.

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The firm makes periodic rental payments to the lessor. The title to the asset now vests with lessor who is naturally also entitled to any residual value the asset might have at the end of the lease period.

The sale and lease back arrangement is beneficial both for the lessor and the lessee. The lessee gets immediate cash, which results in improvement in his cash flow position. The lessor gets the benefit in terms of tax credits due to depreciation.

4. Leveraged Leasing

This form of leasing has become very popular in recent years/ toss type of lease agreement is used for financing those assets, which require large capital outlays. Such a type of lease arrangement involves three parties_ the lessee, the lessor and the lender.

The position of the lessee under a leverage3d leasing agreement is the same as in case of any other type of lease. The lessee agrees to make periodic payments over the basis lease period and gets the right to use the asset over the agreed period of time the position of the lessor, however, undergoes a change. He acquires the asset as per terms of the lease arrangement but finances only a part of the total investment, say, 25%. A person or group of persons in the form of a loan provides the balance of 75% to the lessor. The loan is generally secured by a mortgage on the asset besides assignment of the leased assets rental payments.

Advantages of Leasing

1. Permits alternative use of funds: A leasing arrangement provides a firm with the use and control over the asset without incurring huge capital expenditure. The firm is required only to make periodical rental payments. Thus, it saves considerable funds for alternative uses.
2. Arranges faster and cheaper credit: It has generally been found that acquisition of assets under a leasing arrangement is cheaper and faster as compared to acquisition of assets through any other source. Leasing companies are more accommodating than banks and financial institutions in respect of terms of financing. The total payment are fixed keeping in view the expected profits and cash generation of individual lessees, which is generally not possible in the case of lending by banks and other similar Institutions.
3. Increased lessee's capacity to borrow: Leasing arrangements enable the lessee to utilize more of his funds for working capital purposes in place of low yielding fixed assets. Moreover, acquisition of assets under lease arrangements does not alter the debt-equity ratio of the lessee. Hence, the lessee can resort to further borrowings in case the need arises.
4. Protects against obsolescence: The lessee can protect himself against the risk of obsolescence by entering into Operating Lease arrangement in respect of asset, which become obsolete at an after pace.
5. Boon for small firms: Acquisition of assets by means of a leasing arrangement is particularly beneficial to small firms, which cannot afford to raise their

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capacity on account of paucity of financial resources. It, thus, serves as a boon for technocrats who are unable to arrange funds even for promoter's contribution of margin money as required by the financial institutions.

6. Absence of restrictive covenants: The financial institutions while lending money usually attach several restrictions on the borrower as regards management, debt-equity norms. Declaration of dividend, etc. such restrictions are absolutely absent in the case of financing through a lease agreement.

7. Trading on tax shield: In case of a non-tax-paying lessee, the cost of financing an asset is much higher as compared to a tax-paying lessee since the former cannot take advantage of tax deduction on interest payment. However, when a tax-paying lessor owns the asset, he generally passes a part of the tax benefit to the lessee lessor owns the asset, he generally passes a part of the tax benefit to the lessee by means of lower rental charges. As a result of this favor, the real cost of the asset to the lessee works out to be lower than what it would have been if he were the owner of the asset.

8. Invisible privileges: Under a lease arrangement, the lessee gets a right to use the asset without owing it. Hence, the asset acquired on lease does not become part of the property of the lessee. The rental payments are considered to be of a revenue nature. This results in several invisible privileges to the lessee.

Disadvantages of Leasing

1. Deprived of ownership: In a leasing arrangement, the lessee doesn't get the ownership of the asset. He gets only a right to use. He is, thus unable to recover his rental payments through sale of the asset. Of course, he does benefit in the form of tax saving as a result of rental payments being allowed as an expense for tax purpose.
2. Deprivation of the asset in case of default: In case the lessee makes a default in rental payments, the lessor is entitled, at his will; to take over the asset and the lessee has no right to prevent him from doing so. In case of a capital lease arrangement, the lessor may also file a suit against the lessee for damages.
3. No protection against supplier's warranties: In case of a lease arrangement, it is the lessor who has purchased the asset from the supplier and not the lessee. Hence, the lessee by himself is not entitled to any protection in case the supplier commits breach of warranties in respect of the leased asset.

CHOICE OF LESSOR

Leasing is gaining tremendous popularity in India particularly during the last decade on account of rapid industrialization. Now days, any asset can be obtained on lease, from a transport vehicle to heavy industrial equipment. Leasing entails a long-term relationship between the lessor and the lessee. In order that this relationship continues to be amicable, each party should understand the other's difficulties and fulfill his obligations willingly as per the lease agreement. In other words, it is the

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perception and capability of both the lessor and the lessee, which can make leasing agreement to work effectively as a source of modem business finance.

1. Competitive market rate: The Prospective lessee after having received the lease quotations should ensure that the parameters upon which the quotations are abased are identical and competitive with those prevailing in the market. Besides this, the lessee must ensure that comparisons are made on the basis of rentals with or without the stamp duty. He should remember that it is the lease rental and the residual value of the asset and not the stated interest rate by the lessor that would have impact on the profitability and cash flows of his firm.
2. Supply of correct information: Both the lessor and the lessee need from each other plenty of information to avoid all future problems. For example, the lessee must provide the lessor information relating to nature of his business and its operations. This will help the lessor in understanding the exact requirement of the lessee. The lessor will also like to have details about the lessee company's directors, their financial position, financial position of the lessee based on his income statement and cash flow pattern, etc. the lessee must also give a full and accurate description of the equipment to be purchased to avoid any complications and delay in settlement with the lessor.
3. Service quality: Since in most cases, the liability of maintaining the leased asset rests with the lessor, it is necessary that he is equipped with competent staff – educated and trained – in the proper maintenance of the leased asset. This is all the more important because the staff of the lessor may also be

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required to provide training to the staff of the leases, in the use of the asset leased.

4. Financial strength: The lessor should be a person of sufficient financial means required for absorbing market fluctuations, particularly regarding the availability of funds. This will ensure that the lessee will get the asset at the required time and at the most competitive rates.
5. Professional skills: Leasing business requires specialized professional skill. The lessee may not be familiar with all details of the leasing business. It is the lessor who acts as his mentor and guide the lessor should, therefore, be a person who can (a) explain to the lessee all legal aspects involved in the leasing transaction;(b) structure the lease rentals in a way that they fully reflect all important matters relating to the leasing transaction from the timing of payment to the supplier to the timing of rentals together with actual taxation implications; and (c) advise the lessee regarding the period over which capital cost will be recovered before the leased asset is worn out or becomes obsolete.

ACCOUNTING FOR LEASES

The accounting for leases has been a subject of much controversy in the western countries. The controversies related to the following issues:

1. Whether disclosure regarding lease transactions should be made at all in the financial statements of the lessor and the lessee.

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2. In case the disclosure is made in the financial statements. Whether it should be shown only by way of a footnote or should it form an integral part of the annual accounts.
3. In case, lease transactions were not required to be disclosed in the financial statements. Gradually, disclosures were required about the lease transactions in the form of footnotes into the financial statements. With only the minimal disclosures, leasing was attractive to certain firms as an off balance sheet method of financing.

ACCOUNTING FOR LEASES

Definitions

(a)Lease: An agreement whereby the lessor can convey to the lessee in return for rent the right to use an asset for and an agreed period of time.

(b) Finance Lease: A lease, which transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not eventually be transferred.

Leasing in India

Summary of Developments:

Leasing has proved to be an effective system for financing capital equipment in Europe, Japan and USA. It is now gaining popularity in India also. Of course, land leasing has been quire prevalent in our country from old times. However, leasing of capital equipments is of a recent origin. As a formal instrument of industrial finance,

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the country witnessed the emergence of leasing companies in the early 1970's. The pioneer in the field was "First Leasing Company of India Ltd." (FCL) based in Madras. The company started its business in 1973 and it has slowly grown over years. Since then, a number of other leasing companies have come into existence. They are Mazda leasing, twentieth century leasing company, Ross Morarka leasing Co., Pioneer leasing, express leasing Co., etc. As a matter of fact, in the last five years, the pace at which the number of companies are entering into the leasing business, it can be said that there is a mushroom growth of leasing companies.

It is estimated that there are about more than 600 leasing companies in India providing a package of financial services and more are expected to enter the capital market in the coming years. A a result of amendment in the banking regulation act, 1949, a large number of nationalized banks are also expected to participate directly in the leasing business.

The present structure of leasing industry in India can be categorized as follows:

1. All India financial Institutions
2. Independent leasing companies in the Private sector
3. Finance Companies
4. Group related Leasing Companies

Reasons for popularity:

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The leasing industry is steadily gaining popularity in India on account of the following reasons,

1. A greater role in industrial investment has been envisaged in the eighth plan for the private sector.
2. Greater emphasis on priority sector lending by banks has resulted in reduced availability of banks finance for private sector.
3. Reduced availability of funds for private sector lending with the financial institutions and greater emphasis by the Government on the private sector to its own resources.
4. The withdrawal of the investment allowance with effect from the 1st April 1990. As a result of this withdrawal, it will be more beneficial for a manufacturer to get the plant and equipment on lease as compared to purchasing it.

Illustration 1:

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The Emirated Leasing Ltd. leases an asset to Switcher India Pvt. Ltd., and the terms of lease given below:

Cost/fair value of Asset = Rs.1, 00,000

Lease tenure = 4yrs

Residual value of the asset = zero.

Statutory value of the asset= 40%

Lease rental = Rs. 35,740 payable at the end of the year 1st January 1988.

Inception of lease Required:

1) Journal entries for each year in the books of lessor
2) Show the profit and loss account and balance sheet for the 4 year so far as they relate to this lease.

Solution

(1) The first step is to work out the implicit rate of interest in this lease. This has to be done by trial and error with the help of present value table or by using a financial calculator.

Rs.1,00,000=35,740/(1+I)+35,740(1+I)+35,740/(1+I) = 16%

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COMPUTATION OF FINANCE INCOME

YEAR	Lease rental. (RS.)	Net investment in the lease.(Rs.)	Finance income 16 %(Rs.)	The Lease charge (2-4). (Rs.)
1988	35740	100000	16000	19740
1989	35740	80260	12842	22898
1990	35740	57362	9178	26562
1991	35740	30800	4940	30800
	142960	2,68,422	42960	100000

Computation of Lease Equalization Charge

Year	**Lease charge of column (5) of the previous table**	**Statutory depreciation 40% on WDV**	**Lease equalization (2-1)**	**Lease terminal adjustment A/c.**
1988	19740	40000	(Cr). 20260	(Dr.)20260
1989	22898	24000	(Cr.) 1102	(Dr.)21362
1990	26562	14400	(Dr).12162	(Dr.)9200
1991	30800	8640	(Dr.)22160	(Cr).12960
	1000000	87040		12960

Actual calculation works out to Rs. 4928. However, for the last year the balance in the gross finance income must be taken as figure.

Profit and Loss statement for the year ended 31st December....

Particulars	1988	1989	1990	1991	Total.
Credits:					
Gross income(lease rental)	35,740	35,740	35,740	35,740	142960
Add: Lease Equalization	20260	1120	(12162)	(22160)	(12960)
	56000	36892	23578	13580	130000
Total					
Debits:					
Statutory depreciation	40000	24000	14400	8640	87040
Net income (in relation to leased assets)	16000	12842	9178	4940	42960

Note: The net credit to the profit and loss account represents finance income calculated to give a constant rate of return over the years on the net investment in the asset. In this case every year the profit and loss account is credited with 16% return on the investment in the leased asset, 16% is the implicit rate of interest.

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Balance sheet as at 31st December........

Particulars	1988	1989	1990	1991
Asset side:				
Assets given on lease.	100000	100000	100000	100000
Less: Provision for depreciation.	40000	64000	78000	87040
	60000	36000	21600	12960
Add: lease terminal adjustment account	20260	21362	9200	(12960)
	80260	57362	30800	
Cash balance	35740	71480	107220	142960
Total	116000	128842	138020	142960
Liabilities side:				
Equity	100000	100000	100000	100000
Reserves	16000	28842	38020	42960
	116000	128842	138020	142960
Aggregate amount on account of lease equalization credit.	20260	21362	21362	21362

Note: Balance sheet specimen is not as per schedule VI of the companies Act, 1956

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Date	Particulars	Dr.	Cr.
1988 1st January	Leased A/c Dr.	1,00,000	
	To Bank A/c/		1,00,000
31st December	Bank A/c Dr.	35740	
	To Lease Rental A/c.		35740
	(receipt of lease rental)		
	Profit and loss a/c Dr.	40,000	
	To Provision for depreciation A/c		40,000
	(Depreciation @ 40% on leased asset)		
	Lease terminal adjustment A/c Dr.	20260	
	To Lease equalization A/c.		20260
	(Adjustment to gross income arising from the difference between lease charge and statutory depreciation)		
	Lease equalization A/c Dr.	20260	
	Lease Rental A/c Dr.	35740	
	To Profit and loss A/c		56000
	(The transfer of balance in lease equalization and lease rental a/c to profit and loss a/c.)		
1989 31st December	Bank A/c Dr.	35740	
	To Lease rental A/c		35740
	Profit and loss a/c Dr.	24000	
	To Lease rental A/c		24000
	Lease terminal adjustment A/c Dr.	1102	
	To Lease equalization A/c		1102
	Lease equalization A/c Dr.	35740	
	Lease Rental A/c Dr.	1102	
1990 31st December	To Profit And Loss A/c		36842
	Bank A/c Dr.	35740	
	To Lease Rental A/c		35740
	Profit and loss A/c Dr.	14400	
	To provision for depreciation A/c		14400
	Lease equalization A/c Dr.	12162	
	To lease terminal adjust A/c		12162
	Lease rental A/c Dr.	35740	
	To Profit and Loss A/c		35740
1991 31st December	Profit and loss A/c Dr.	12162	
	To Lease equalization		12162
	Bank A/c	35740	
	To Lease rental A/c		35740
	Profit and loss a/c Dr.	8640	8640
	To provision for depreciation A/c		
		22160	
	Lease equalization A/c Dr.		22160
	To lease adjustment a/c	22160	
	Profit and loss A/c Dr.		22160
	To Lease Equalization A/c	35740	
	Lease rental A/c Dr.		35740
	To Profit and loss A/c.		

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QUESTIONS

1. Why leasing is becoming more popular these days as a method of finance.
2. Define leasing. Explain the different types of leases.
3. State concisely the difference between the operating and financing lease giving an example of each.
4. Discuss the advantages and disadvantages of leasing.
5. Leasing transaction accelerates industrial growth comment.
6. Mention the guidelines to treat a lease in the financial statements of the lessor and the lessee.
7. What is leasing? What is its need? Explain the accounting practices relating to lease in the context of Indian Companies.

LESSON-21

SOCIAL ACCOUNTING

Earning profit is necessary for the survival and growth of business. So the main emphasis for evaluation of a business unit was on profitability. Business units now-a-days function under a particular political, economic and social environment. But the social aspect has so far been ignored for evaluation of a business unit.

A business organization is a social unit because its activities vitally affect the society and its members and it uses the society resources and produces goods and services for which the society is the ultimate customer. It is the society that will determine the parameters within which business will operate,. Also the society provides the infrastructure and the facilities without which a business unit cannot function at all. The society, therefore, expects that businesses organizations of the society, it will strengthen it.

Social Responsibilities of Business

Infact, unless a business unit earns profits and acquires financial strength, it will not be in a position to discharge social responsibilities. A firm that is losing money will always be tempted to take the short cut to profits and may thus inure the society in many ways like production of adulterated and sub-standard goods, under weighing

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paying lower wages, evasion of taxes, increasing prices etc. Only strong firms can undertake proper service of the society. Therefore, the very first social responsibility of a firm is to earn profits and be strong. The other social obligations of a business may be briefed as follows.

1. Resources

It is the duty of business unit to use the various resources like materials, labor capital and machines in the best possible manner and avoid wastage. Wastage of resources is anti-social where there is an acute shortage of resources. On the other hand, increasing production by using resources in the best possible way contributes to increase in productivity.\

2. Products

The business unit should give priority to those products and services which the society really needs- bread and butter must have priority over cakes. Also the products must not cauwse any harm or injury to the user.

3. Customer

Customers suffer from a continuous price rise and deterioration of quality and there is not guarantee of purity of goods. It is the social responsibility of business unit to provide quality of goods at reasonable price. There should be no fleecing of customers lay the business community.

4. Employees

It is the duty of the employer to be so efficient as to provide the means to his employees who have economic, psychological and social needs. The employers who can afford to pay good wages but still deny them to the workers are guilty of a social crime because they are subjecting their children of the employees to eternal poverty. Management has a particular duty towards employees to see that they are not denied their legitimate satisfaction at work.

5. Society

A business firm, being an important member of the society must not do anything to undermine the accepted social values. The business community is to help the government in solving social problems associated with industrial development. The business community can also help the society by constructing temples, schools, colleges, hospitals and adopting villages for spreading health knowledge and removing illiteracy.

6. Shareholders

Managements will do incalculable harm to economy if they do not manage the affairs well and lead to financial losses among shareholders since that may lead to the drying up of further investment. The lease that management can do is to be truthful and keep share holders and investors informed of the situation.

Meaning of social Accounting

The terms social accounting is of recent origin. "Social audit" "Socio economic accounting" and "Social information system" and "Social responsibility accounting" are the other terms interchangeably used for the

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term "Social accounting". The commercial evaluation of business units will be complete only it takes into consideration social cost and benefits associated with them.

1. Ralph Eates defines the term social accounting "as" the measurement and reporting internal and external of information concerning the impact of an entity and its activities on society.
2. Elliot uses the term "Social responsibility accounting ". According to him, social responsibility accounting is a systematic assessment of and reporting on those parts of a company's activities that have social impact. Social responsibility accounting, therefore, describes the impact of corporate decisions on environment pollution, the consumption of non renewal resources, and ecological factors, on the rights of the individuals and groups, on the maintenance of public services, on publi9c safely on health and education and many other such social concerns".

Social cost benefit Approach

It is difficult to measure the social cost and benefit of a particular project in monetary terms. An analysis of different social aspects associated with the profits is made to take a decision about the acceptability or rejection of a project on social grounds. Social cost benefit ratio method can be used for the measurement of social cost benefit of a project. A project having lower cost benefit ratio is prefaced over a project having higher cost benefit ratio. In other words, the lower the social costs, the better it is. Social benefits for calculating this ratio include all economic and non-economic benefits which society likely to receive on account of the project. Similarly, social costs include all cost which the society is likely to pay in monetary terms for the project.

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Social cost benefit approach may be presented in the form of accounts as indicated below

Dr Employee's Account Cr

1.	Shortfall of wage below the living wages	1	Excess wage above the living wage leavels.
2	Strains and stresses because of unethical practicals	2	Development of skills, talent etc.,
3	Injustice there may be there	3	Job satisfaction and happiness at work
4	Balance Cr to the society's account	4	Balance Dr to the society's Account.